

INDUSTRY GROWTH PARTNERSHIPS:

ACHIEVING LEBANON'S TRUE ECONOMIC POTENTIAL

INDUSTRY CLUSTER DEVELOPMENT STRATEGIES

Prepared by:

Lebanese Industry Stakeholders,

SRI International

and

Lebanese American University

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INTRODUCTION

Lebanon's economy is poised to experience a period of accelerated and much needed growth in the years immediately ahead. This growth will be built upon the foundation of political stability and infrastructure reconstruction achieved over the past decade, and will be fueled by the nation's unique level of consensus favoring a pro-market, private sector-led development strategy. If undertaken correctly, the economic activities which collectively yield growth will provide direct benefits to all segments of Lebanese society, thereby creating a catalytic source of national unity and cohesiveness.

The outcome just described is clearly possible but is not assured. The building blocks for economic expansion are being put into place. The intricate task of establishing workable political processes and governmental systems is well under way. The enormously expensive undertaking of restoring and upgrading Lebanon's physical infrastructure is bearing fruit, but at a cost. It is now up to the nation's entrepreneurial private sector to assume responsibility for generating new and expanded productive enterprises needed to provide the jobs, income, foreign exchange and tax revenues that will feed growth and the improvement of standards of living.

If productive investments do not take place, then Lebanon's economic fortunes will be reversed. In this outcome, the inevitable course of events will be that the nation's massive buildup of government deficits and indebtedness will "take charge" and shape the country's economic processes and results. The financial and real estate market "bubbles" will burst, and regardless of whether the landing is "soft" or "hard," real incomes and living standards will decline, resulting in undesired social and political ramifications.

Every economy faces downside risk, and it is important to stress that Lebanon's economic balance sheet shows that the nation's assets far exceed its liabilities. Nevertheless, if the positive outcome is to be achieved, it is critically important for Lebanon's core productive industries to become organized and pursue productive investment opportunities much more aggressively than they have over the past few years. At the same time, the government needs to systematically remove policy-induced constraints and become a more effective partner with the private sector. Attaining that end is the goal of this initiative, as described in this report.

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. 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 overall project has been carried out by SRI International, in collaboration with THE Lebanese American University (LAU). 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. LAU, through its Center for Sponsored Research & Development (CSR), is a leading institution of higher learning well known for its business outreach and community service. On behalf of SRI and LAU we 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. There is a unique consensus among both public and private sectors 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 bode well for the comprehensive nation building that is now under way in Lebanon.

"This report is based on the results of a project conducted under support provided by the United States Agency for International Development (USAID) Mission in Lebanon. The findings and recommendations of this

report, however, are solely those of the project team, and do not necessary reflect the views of USAID."

I. LEBANON'S ECONOMIC NEEDS: A DIAGNOSTIC ASSESSMENT

For many reasons it is important for Lebanon to "move on" from its war experience and turn its full attention to "invent" its future. Nevertheless, it is virtually impossible to assess needs and craft a growth strategy without referring to the war, since it so pervasively defines Lebanon's economic conditions and requirements.

A. Domestic Economic Performance

Lebanon's domestic economic performance is often perceived, whether appropriately or not, through the prism of Lebanon in 1974, which remains the reference point or benchmark from which Lebanese measure their economic status. There is a clear tendency for many to believe that the country's previous position as the most open and prosperous country in the region and the center for regional trade, finance, education, medicine, tourism and culture can be recaptured.

A more realistic approach, and one held especially by the younger generation of Lebanese professionals, is that while the economy took a "time out" for a protracted war lasting over 15 years, the rest of the world moved on, and so the conditions and lifestyles of 1974 cannot be restored. In any case, from an analytical standpoint it is appropriate to examine Lebanon's economic performance in three separate time frames: Pre-war Lebanon, the war years, and the post-war experience.

Pre-War Performance

Looking first at Lebanon's pre-war performance, despite occasional disturbances, the economy achieved solid economic growth and rising incomes over the period between 1950 and 1975. Yearly GDP growth in real terms averaged 6 percent, and inflation was held to an average of 3 percent annually. Per capita income was estimated in 1974 to be \$634, approaching that of Portugal and about three times the levels prevailing in Egypt or Jordan.

In the mid-1970s, Lebanon was considered a middle-income country. The exchange rate was relatively stable. Net capital inflows and invisibles earnings covered the chronic trade deficit, contributing to ample foreign currency reserves at the Central Bank. Government revenues in that period equaled 20 percent of the GDP, but expenditures were only 15 percent, generating budget surpluses.

Lebanon's enviable record resulted from a combination of geography, culture and history. In a world not yet linked globally in terms of communications and technology, Lebanon was geographically well situated to serve as an intermediary between Europe and the Near East, as well as to act as a business and financial center for the regional market. The nation's cultural diversity, social tolerance and dedication to private enterprise and an open economy made Lebanon attractive to Europeans and regional nationalities, and provided the milieu in which the Lebanese could develop their own skills.

The Impact of War

Lebanon's internal war was episodic but long lasting. It wreaked great physical damage, virtually marginalized the central government and seriously weakened the country's economic and social institutions. Individual Lebanese who lived through this turmoil were forced to place their highest priority on assuring personal safety and securing their economic survival.

The nation's tourism, financial and trading activities, the pillars of the economy, all but disappeared. A host of factories, both large and small, were bombed repeatedly. Land mines were set in both rural and urban areas. Many entrepreneurs and their families fled the country in order to gain personal security. Retail establishments closed their doors. Levels of per capita income and standards of living fell precipitously. In short, the nation was devastated by a

continuous downward economic spiral that led eventually to little more than subsistence activities.

Recent Economic Developments

The initial transition from war to peace was tumultuous in economic terms. In 1990, Lebanon's GDP is estimated to have shrunk by around 14 percent. However, in 1991 the economy bounced back strongly, with growth estimated at 38 percent. In 1992, inflation on the order of 120 percent triggered a flight from the pound and the exchange rate in September of that year reached LL2,830 to the dollar. Net GDP growth nevertheless was estimated at 4.5 percent in 1992.

Over the past few years, economic activities have been closely associated with Lebanon's reconstruction efforts. Much has been accomplished in terms of restoring Lebanon's physical infrastructure. The telecommunications system has largely been rebuilt, and the new airport is in operation. Electric power has been restored to a level where most of the country has 24-hour a day power. Much of the water supply system now functions and major construction projects are under way for roads, the port of Beirut and public buildings. Private construction has also been active in restoring or building hotels, offices, shops and apartments.

The structure of Lebanon's economy has changed relatively little from pre-war to post-war times. During the war, trading and other services were handicapped, giving agriculture a proportionate boost. At present, however, agriculture is of even less importance than previously thought. The share of industrial output has returned to that in pre-war years, and tourism and other services are again becoming an important element in the economy. The rebuilding process, together with increased income, has greatly expanded Lebanon's merchandise imports. This means that Lebanon can maintain current consumption and savings levels only through substantial net inflows of services income, capital, and remittances.

Both domestic and foreign direct investment has been more limited than expected. Most investment has been directed toward real estate and portfolio investments. Investment in productive activities has been made, especially in selected areas such as construction materials and banking, but this trend has witnessed serious deterioration. Factors inhibiting productive investment include:

Perceived political risks, mostly external, but some internal.

Apprehension over the direction of Lebanon's economy and concern over the sustainability of the government's macroeconomic strategy.

The small size of the local market.

High local costs for labor, real estate, transportation, etc., along with the belief that the Lebanese pound is overvalued, which detracts from price competitiveness in regional/world markets.

The availability of attractive investment alternatives, including Treasury securities, fixed deposits, and carefully selected real estate investments.

A number of policy-induced disincentives also constrain investment in productive activities. These include but are not limited to the following:

Lebanon lacks effective protection for intellectual property rights, creating a disincentive for high technology and media investments.

There is no formal competition policy, which adds to the perception that Lebanon's economy is controlled by a small number of business groups.

There are serious concerns regarding Lebanon's labor policy, especially the issue of social security administration, costs and services.

The tariff structure impedes industrial activity and distorts agricultural trade but is difficult to change since it is a major source - approximately 45 percent - of government revenue.

Finally, dealing with Lebanese government bureaucracy is not always an easy or expeditious process.

Investors can accept -- and discount for -- political risk and structural inefficiencies when the economic returns are sufficiently high. Alternatively, if the prospective economic returns are modest, then the policy and overall operating climate must be very attractive. Currently, the structure of disincentives and incentives tilts in favor of nonproductive rather than productive investments.

The world has changed during the period that Lebanon effectively receded from the international economic scene. The tremendous growth of oil revenues in Saudi Arabia and the Gulf has come and gone. Dubai, Bahrain and Kuwait have emerged as financial/entrepot centers. The economies of Egypt and Turkey have expanded greatly, and Jordan has changed from a sparsely populated state to a modern economy in terms of business, finance and trade. The expansion of the European Union, the emergence of East and Southeast Asian economies, and more recently the collapse of the Soviet Union and eastern bloc all have made the world of the 1990s a vastly different place.

Over this period, Lebanon did not participate in many rounds of growth, modernization and competitiveness enhancement. In fact, in many respects Lebanon's operating environment deteriorated. The tendency for the government to intervene in the economy, begun out of necessity during the war years to solve pressing social or economic problems, has led to distortions in the economy which are largely unacknowledged. In addition, many segments of the private sector have not made the investments needed to restore international competitiveness.

In sum, Lebanon has made remarkable progress in the 1990s, but growth has now leveled off considerably. This in turn gives rise to the need for concerted efforts to restore the nation's economic momentum.

B. 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.

A major issue confronting Lebanon is its need to maintain balance in its overall payments accounts despite the deficit in merchandise trade. Only through preserving adequate foreign exchange reserves can Lebanon maintain the exchange value of its currency, and hence sustain sufficient confidence on the part of foreign investors to buy Lebanese public and private debt instruments. The trade deficit is covered by several factors -- some exports and re-exports (including unreported transactions), invisibles income from services such as tourism, remittances from overseas Lebanese, and capital inflows.

C. Lebanon's Macroeconomic Policy Framework

Lebanon's senior economic management team is sophisticated according to 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.

The government to date has been able to finance its deficits through the issuance of Treasury securities denominated in local currency in maturities ranging between 91 days and two years. Seventy percent of these securities are held by Lebanese commercial banks, and only 20 percent by individual investors. Returns on public debt instruments have reached as high as 28 percent, but now range between 14 and 18 percent depending on the length of maturity. For the banks, these have offered an opportunity to earn attractive returns on capital in the face of weak domestic demand for loan credit.

The Lebanese government kept to its reconstruction plan with little deviation until late in 1997, when it acknowledged that some modification might be in order. The government's budgets postulate substantial shortfalls between revenues and expenditures, leading to increasing public debt and an increasing debt service burden. Aggravating the situation is the fact that government deficits have consistently exceeded the stated budget targets. To finance these deficits, the government's macroeconomic policy strategy has been to maintain control over the money supply both to reduce inflation and to provide interest rates high enough to make treasury securities attractive to investors.

There is a growing consensus in Lebanon that continued large government deficits are unsustainable. Interest payments on the public debt now amount to about one half of the Government's proposed budgeted expenditures. Net public debt is now equal to the whole estimated annual GDP of Lebanon.

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. Increasing revenues implies either new taxes or higher tax rates. On the expenditure side, there are questions as to the efficiency of current government spending in terms of value received for money spent. On the other hand, the government has been faced with complaints about the lack of spending for social programs such as education, community rebuilding and agricultural improvement.

It is clear that in the near term, Lebanon will not "grow" itself out of its public sector deficits or cover its public debt. This suggests that the burden of adjustment will rest on new fiscal measures. Ultimately, however, the only viable solution to the nation's macroeconomic dilemma is growth in productive economic activities. By creating new income and employment, these not only will generate increases in government revenues, but also will reduce pressures for the government to provide employment and social services.

D. Lebanon's Commercial Policy Framework

As in most parts of the world, Lebanon's policy-makers have recognized the need for a sound commercial and economic policy environment which maximizes competitiveness, efficiency, and the creation of productive employment. After several years of concerted efforts to re-establish a competitive commercial environment, it is useful to stand back from the process to evaluate the strengths and remaining weaknesses in Lebanon's commercial policies.

Given the importance of a business-friendly commercial policy environment for private sector development, it is imperative for policymakers to identify feasible policy alternatives, and to assess their effectiveness. To this end, cross-country experiences can be utilized to examine specific policy approaches and the lessons learned from their successes and failures in enhancing economic performance. Cross-country data is also useful for conducting policy benchmarking, which is an effective technique for assessing the comparative position of a country's commercial policy regime against its competitors in attracting international investment and trade.

This section presents the findings of an analysis conducted by SRI to identify those policy practices which are conducive to private sector development and sustained economic growth. The methodology is designed to allow cross-country comparisons of overall commercial policy regimes through summary country policy scores, which describe the degree to which commercial policies are business-friendly as well as competition-based.

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The policy variables analyzed are classified under nine categories:

- 1. Business start-up 6. Domestic investment**
- 2. Pricing\interest 7. Foreign investment**
- 3. Import 8. Labor**
- 4. Export 9. Taxation**
- 5. Foreign exchange**

The policy variables were categorized so that they could be assessed as policy groups in forming the overall commercial policy environment. Such classification can also accommodate cross-country comparison in each individual policy category. SRI designed a rating system which assigns summary policy scores to each nation.

Under this system, both quantitative and qualitative information is converted into a set of policy scores. The scores of the policy variables within the same policy category are then summed and harmonized. The Total Score (TS) for each country is obtained by summing the weighted scores from all the policy categories. The maximum achievable Total Score for a country is 100. Total Scores can be compared across countries as a summary description of the commercial policy environment. In addition, comparisons and benchmarking can be conducted in each policy category by comparing the Policy Category Scores across all countries or groups of countries.

E. Benchmarking Lebanon's Commercial Policies Against Regional Countries

This section compares Lebanon's commercial policy scores with those of other countries in the Middle/Near East. The countries were chosen as competitors or models against which Lebanon can be benchmarked in terms of "policy competitiveness."

Country	Imports	Exports	Tax	Investment	Foreign Direct Inv.	Business Start-up	Pricing/ Interest Rates	Foreign Exchange	Labor	Total
Lebanon	12	8	16	4	4	4	9	16	8	81
Jordan	12	6	16	8	6	4	9	8	8	77
Bahrain	8	6	16	4	6	6	9	8	6	69
Cyprus	8	8	12	4	8	6	6	12	4	68
Morocco	8	8	4	6	8	6	9	12	4	65
Tunisia	4	8	8	6	6	8	7.5	12	5	64.5
Egypt	8	6	4	6	5	4	9	16	4	62
Average	8.6	7.1	10.9	5.4	6.1	5.4	8.4	12.0	5.6	69.5

A. An Economic Growth Initiative for Lebanon

Republic of Lebanon
Office of the Minister of State for Administrative Reform
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