CAPTURING THE STATE:
A POLITICAL ECONOMY OF LEBANON’S PUBLIC
DEBT CRISIS 1992-2004

A Research Paper presented by:

SAMER SROUJI
(LEBANON)

In Partial Fulfillment of the Requirements for Obtaining the Degree of:

Master of Arts in Development Studies
Specialisation:

International Political Economy and Development

Members of the Examining Committee:
Prof. Richard Robison
Dr. Karel Jansen

The Hague, The Netherlands
December 2005
This document represents part of the author’s study programme while at the Institute of Social Studies; the views stated therein are those of the authors and not necessarily those of the Institute.

Research papers and theses are not made available for outside circulation by the Institute.

Enquires:

Postal Address:
Institute of Social Studies
P.O. Box 29776
2502 LT, The Hague
The Netherlands

Telephone: -31-70-4260460
Telefax: -31-70-4260799
e-mail: postmaster@iss.nl

Location:
Kortenaerkade 12
2518 AX, The Hague
The Netherlands
Then the traveller walked on, wondering in his heart. And he met a very old man, and saluting him he said,

"Sir, upon this road I have met three men who live in the neighborhood and I have asked each of them about this field, and each one denied what the other had said, and each one told me a new tale that the other had not told."

Then the old man raised his head, and answered, "My friend, each and every one of these men told you what was indeed so; but few of us are able to add fact to different fact and make a truth thereof."

Khalil Gibran,
Lebanese Poet,
Contents

Acknowledgements p4
Timeline p5
List of Charts and Tables p6

Chapter 1: Introduction p7
1.1 Methodology p10
1.2 Limitations p11

Chapter 2: Theories and Notions of State “Capture” p12
2.1 The Neoliberal view p12
2.2 The New Institutional Economics view p14
2.3 The Marxist view p16
2.4 Relevance p17

Chapter 3: The Makings of the Public Debt Crisis: A Critical Review p20
3.1 Lebanon’s Political Economy p20
3.2 The Debate around the Reconstruction Program p21
3.3 Crisis Management and the Foreign Debt p28

Chapter 4: Capture: The Economic Context p30
4.1 Treasury Bill Rates p31
4.2 Performance & Practices of Commercial Banks p34

Chapter 5: Capture: The Political and Institutional Context p38
5.1 Syria and its Allies p40
5.2 The Challenge of the Selim Hoss Administration p42

Chapter 6: Implications of The Capture p45
6.1 Bank Lending and “Crowding Out” of the Private Sector p45
6.2 Inequality p48

Chapter 7: Conclusion: Moving beyond the “Neoliberal-Monetarist Impasse” p50

Bibliography p52

Word count: 15,000
Acknowledgements

This research paper would not have been possible without the help of several individuals, and to them I would like to express my gratitude. Samah Wehbi at Deloitte & Touche, Beirut, who provided me with much useful data. Walid Khadduri at Al-Hayat newspaper in Beirut, Georges Corm for his insightful work, Nisrine El-Ghaziri and Donna Andrews here in The Hague for their help and support, Nora Shawwa in Cyprus for her encouragement, Karin Hirdes and Mira Chowdhury, our wonderful course administrators. And my parents, for their unconditional support and for putting up with my mood swings this past year.
## Timeline

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975 - 1990</td>
<td>Lebanese civil war</td>
</tr>
<tr>
<td>1990 Aug</td>
<td>Taef Peace Accord</td>
</tr>
<tr>
<td>1992 Oct</td>
<td>Rafiq Hariri elected prime minister</td>
</tr>
<tr>
<td>1994 Oct</td>
<td>Lebanon issues first Eurobond</td>
</tr>
<tr>
<td></td>
<td>Dec Hariri resigns, Selim Hoss takes over as prime minister.</td>
</tr>
<tr>
<td>2000 Oct</td>
<td>Hariri returns as prime minister</td>
</tr>
<tr>
<td>2002 Nov</td>
<td>Paris II conference</td>
</tr>
<tr>
<td>2004 Oct</td>
<td>Hariri resigns, Omar Karami takes over as prime minister</td>
</tr>
<tr>
<td>2005 Feb</td>
<td>Hariri and 22 others killed by a bomb in Beirut.</td>
</tr>
<tr>
<td></td>
<td>Feb Independence demonstrations force government to resign</td>
</tr>
<tr>
<td></td>
<td>Apr Syria withdraws all troops from Lebanon following independence</td>
</tr>
<tr>
<td></td>
<td>demonstrations and pressure from UN Security Council.</td>
</tr>
<tr>
<td></td>
<td>May-Jul First elections in an independent Lebanon. Fuad Seniora</td>
</tr>
<tr>
<td></td>
<td>becomes prime minister.</td>
</tr>
</tbody>
</table>
List of Charts and Tables

Chart 1: Composition of Public Debt 1993 – 2004 p8
Chart 2: Debt Servicing and Capital Expenditure as % Government Revenues p26
Chart 3: Debt Servicing and Capital Expenditure as % Government Expenditure p27
Chart 4: Select Eurobond Yields p29
Chart 5: Evolution of Interest Rates on 3-month Treasury Bills p32
Chart 6: Commercial Bank loans to Government and Private Sector as % of Total Assets p46
Chart 7: Commercial Bank loans to the Government and Private Sector as % of GDP p46

Table 1: Lebanon GDP Structure p21
Table 2: Financing the Horizon 2000 Reconstruction Plan, the 3 Phases p22
Table 3: Distribution of Tax Revenues for Select Middle Eastern Countries p24
Table 4: Lebanese Government Annual Deficits 1992-2002 p25
Table 5: Evolution of Nominal Interest Rates pre-, post- Paris II p29
Table 6: Average Interest Rates on 3 month Treasury Bills 1993 – 2002 p32
Table 7: Central Bank Foreign Reserves Excluding Gold 1993 – 2004 p33
Table 8: Consolidated Assets of Lebanese Commercial Banks 1994 – 2003 p34
Table 9: Commercial Bank lending rates p36
Table 10: Distribution of income in Lebanon p48
1. Introduction

In 1993, the year the government of Prime Minister Rafiq Hariri, launched its post-war reconstruction program financed by domestic borrowing, Lebanon’s public debt stood at LL 6,650 billion ($3.6 billion) equivalent to 50 percent of GDP. Of this, only 8.5 percent was foreign currency denominated. By 2004, the debt stood at LL 52,540 billion ($34.8 billion), equivalent to 185 percent of GDP, one of the highest public debt-to-GDP ratios in the world. The foreign currency component of this debt now represented 52.7 percent of the total, making Lebanon more vulnerable to a debt crisis as those witnessed in Latin American in the 1980s, which had forced these countries into structural adjustment. The same year World Bank Vice President François Bourguignon warned that Lebanon’s situation was “totally unsustainable,” and pressed the government to make progress on structural reforms and privatization.¹ For the first time in its modern history, Lebanon – one of the economic success stories of the Middle East before the 1975 – 1990 civil war – was on the verge of a full blown debt crisis and increasingly at the mercy of its foreign creditors and the Bretton Woods institutions.

The rapid accumulation of public debt meant that the government ran into problems early on meeting the debt servicing burden, which was exacerbated by continued high interest rates in the local debt market. Between 1993 and 2004, debt servicing absorbed an average 40 percent of all government expenditures, and 74 percent of revenues. By comparison, capital expenditure (i.e. spending on reconstruction) averaged only 13 percent of total expenditures, or 26.8 percent of revenues.²

Despite promises that their small Mediterranean country would be restored to its pre-war eminence as the financial and services hub of the Middle East, Lebanese by the late 1990s had to live with the realities of economic recession, including losses in output, increased unemployment and increasing social inequalities. Young people continued to leave the country in large numbers in search of jobs and better lives in the West, while the government struggled to meet debt servicing obligations and a way out of the “vicious circle” of debt and deficits. In November 2002, the government finally turned to the Paris Club to request a rescue package. The loans to

² Data compiled from The Economist, annual country reports.
refinance the debt were duly received, but not without conditionalities in the form of requirements for structural and public sector reforms. Even with the aid package the international financial institutions continued to warn that the economic situation was precarious.

Since the outset, members of the Hariri government have insisted that the public debt burden was “inevitable” given the reconstruction needs following the war. They acknowledge that some developments, such as the failure of the Arab-Israeli peace talks and regional instability, dampened economic predictions and required the government to spend more than expected on security. But this has not shaken their confidence in the policies of the post-war period or sparked a rethink of the guiding Neoliberal ideology. To be clear, this was a government committed in its rhetoric to Neoliberal principles of minimal state involvement in the economy, privatization, low inflation and market-determined interest rates. Yet if Neoliberal prescriptions were followed, why did Lebanese policymakers not read market signals and allow government borrowing to reach unsustainable levels. And why did rational bankers keep lending to the government in the knowledge that it may one day be unable to meet its obligations. Clearly there is a failure here, but is it a failure of the government, of regulatory institutions, or of the market?

Chart 1: Composition of Public Debt 1993 – 2004 (in LL)

Source: Data compiled from The Economist, various country reports. The chart shows an increased reliance on government borrowing in foreign currency, especially after 1997. This was due to increased reliance on more foreign currency debt.
due to the lower yields the government could obtain by taking on foreign currency debt, as well as an official policy of “debt swaps,” exchanging domestic for foreign-currency denominated debt.

More recently, Lebanese intellectuals and dissidents have been questioning the motives and rationale behind the high government borrowing of the 1990s. Economists have found evidence of manipulation of fiscal and monetary policy that has favored the interests of the banking sector over the non-banking private sector. “It is legitimate to ask,” wrote Lebanese economist Atif Kubursi in 1999, “why the government has allowed the debt to increase to this high level and why it has accepted these high debt servicing charges. In other words, did the government have any choice regarding the debt level or its levels of servicing?” (Kubursi, p79) Political scientists have noted the strange nature of the Hariri government, the large overlap of private and public sector interests, and its relative autonomy from traditional state institutions. This has led them to speak of the emergence of a “parallel” state structure in the post-war period.

The aim of this paper is to extend and build on this discussion, by arguing that Lebanon’s public debt crisis can be explained as resulting from a capture of the state in the post-war period. This paper argues that key state institutions were captured by a politico-business elite under the Hariri government. This capture allowed the elite to manipulate monetary and fiscal policy in favor of the banking and financial sector, to which they were closely linked. It is this manipulation of monetary and fiscal policy that drove Lebanon to accumulate an unsustainable debt and generated negative consequences for the productive sectors. What role did Neoliberal ideology have in the making of the debt crisis? This is a multifaceted question and is not the focus of this paper, which is about reframing the public debt crisis as a case of state capture. However, what can be said is that Neoliberal ideology served as a powerful cover for the manipulation of policy and a host of oligopolistic, self-serving practices, by implicating the “market” as being responsible for these developments, whether in the determination of interest rates or the handing out of private contracts. The ideology also gave the government the “stamp of credibility” from the Bretton Woods institutions, which did not (at least in public) raise questions about these practices. Finally, certain Neoliberal prescriptions such as a low overall tax rates and high interest rates (adopted in parallel with the reconstruction program) did contribute directly to the makings of the public debt crisis by worsening government fiscal deficits.
In seeking to understand how and why the public debt crisis emerged this paper poses four questions. First, is Lebanon’s public debt crisis the result of a “capture” of the state? Secondly, how can we understand that capture in relation to existing theories? Thirdly, what was the political and institutional context that allowed this capture to occur? Fourthly, what have been the consequences for post-war Lebanese society and economy? In asking these questions this paper seeks to reframe the public debt crisis. Furthermore, in order to understand the notion of state capture we will draw on different theoretical approaches which will help us to understand conceptually what is meant by a capture of key state institutions and the resulting manipulation of policy that led to the debt crisis.

1.1 Methodology and Organization

This paper will review different theories of state capture to come to a clearer understanding of what is meant by state capture, and to draw insights that are relevant to explain the makings of the public debt crisis. No one theory will be used, but the purpose is to come to a clearer understanding of these theories in order to explain the Lebanese case. This is in line with the general move away from universalist theories of the state and efforts to look more at specific case-studies giving attention to the local context. (Hyden, p29)

In relation to the nature of the post-war Lebanese state and its institutions, I will draw on the writings of supporters and dissenters of the period, their views on the nature of the public sector as well as material learned during interviews in Lebanon. This will help to explain the political and institutional context that allowed or facilitated the rise of the politico-business elite and their capture of key state institutions.

To assess the consequences of the public debt crisis on the society and economy, I will draw on economic data available from reports of the finance ministry, the central bank as well as data given by the Economist Intelligence Unit. Studies on poverty and employment in the 1990s will also be used.

The paper is organized as follows: Chapter 2 looks at theories and notions of state capture. Chapter 3 introduces Lebanon’s political economy and presents a critical review of the makings
of the public debt crisis. Chapter 4 analyses the economic context of capture and looks specifically at how fiscal and monetary policy was manipulated to favor the banking sector. Chapter 5 analyses the political and institutional context in which the politico-business elite came to control key state institutions, allowing them to manipulate policy, and links this back to our theories of state capture. Chapter 6 looks briefly at the implications of the capture on Lebanese society and chapter 7 concludes.

1.2 Limitations

Because the focus of this paper is on explaining the public debt crisis through the lens of state capture, we will be unable to look in detail at the implications of the capture on other policy issues such as privatization, public sector reforms or to look in detail at the struggles that took place over fiscal policy and budget allocations.

Secondly, we will be unable to look in detail at the role of Syria in relation to the capture of the state and the public debt crisis because the details of the dealings between Syria and key Lebanese political figures in the post-war period are obscure. Suffice to say that Syria had an important say over who held the posts of prime minister and president and most of the important ministerial positions in the post-war period. It also gave its approval to the reconstruction plans of the Hariri government as a prosperous and more stable Lebanon would suit its interests.

Thirdly, limitations on access to data meant that I could not analyze in detail the evolution of yields on foreign currency debt. However, the foreign currency component of the debt only became important after the year 2000, when the (majority local currency-denominated) debt had already reached unsustainable levels and the government started swapping local for foreign-currency debt. In looking at manipulation of monetary and fiscal policy therefore, the period 1993-2000 is therefore more relevant.

---

3 Syrian forces were mandated to stay in Lebanon under the 1991 Taaf Accord that ended the Lebanese civil war. However, this dominance soon stretched to the political realm as Syria ensured its own favored candidates and allies were well represented in the government. It also played different sides off each other.
2. Theories and Notions of State “Capture”

Political economy theories differ in their understanding of the notion of state capture, as well as on the nature of the state. These theoretical disagreements stretch to the economic, political and ideological levels. The Neoliberal view of state capture currently predominates in policy circles, in line with the dominance of Neoliberal ideology promoted by the international financial institutions (IFIs). It has taken on a particular relevance since the 1990s as the IFIs have turned to pay more attention to issues of governance, accountability and public sector reform in developing countries (Hyden, p33). However, other notions of state capture, including those of the neo-institutional economists and the structural Marxist schools continue to be relevant to our understanding of the politics behind economic and monetary policies, and on the distributive implications of these policies, whether in developing or developed states. These theories can give us a more complex understanding of the politics behind economic decisions and how these can result, for example, in the accumulation of an unsustainable public debt or other outcomes.

This section will review how different political schools – the Neoliberal, new institutional economists and Marxists – understand the notion of state capture. We will then assess the relevance of these views for Lebanon’s political economy.

2.1 The Neoliberal view

Ideologically, the predominant neo-liberal approach sees the state and its representatives more of the problem than the solution when it comes to economic policy. It sees state capture as occurring when it is policymakers – and not the market – that control economic policy, whether in relation to taxes rates, determining interest and exchange rates, or running strategic sectors of the economy. In ideological terms, it is believed that policymakers are inevitably corrupt and that they will use the power they are given by the state to allocate rents and practice patronage. (Robison & Hadiz, p4) In economic terms, the assumption behind this view is that the market, through the forces of supply and demand, is better able to determine interest and exchange rates and that these market-determined rates will result in the most optimal allocation of savings towards investment projects. If policymakers capture these policies, they will create “distortions”
that will prevent an optimal allocation of savings and investments. Underlying this view, of course, is a belief in the self-regulating market.

This view of state capture has meant that throughout the 1980s and 1990s, and by means of the Structural Adjustment Programs (SAPs) or other reforms applied on many indebted developing countries, the IFIs have sought to prevent a “capture” of policy by reducing the power of policymakers to formulate economic policy. Concretely, this has meant, among other things, pushing for market-determined exchange and interest rates, liberalizing capital flows, giving the private sector control over all credit allocation, making central banks “independent” and pushing for the privatization of key economic sectors. However, despite these efforts, post-SAP many countries ended up in a worse condition than before. (Toussaint, p159) The reason is that many of the economic and political assumptions behind the Neoliberal view of capture were simply wrong.

At an economic level, the principle of market-determined exchange and interest rates often overlooked the structural problems facing developing countries in the global economy. Their shortage of foreign currency meant that fluctuations in capital flows, whether from foreign loans or investment, meant unpredictable and damaging exchange rate movements. Tight monetary policies, to prevent inflation, often overlooked the fact that inflation in most developing countries (LDCs) is due not to an oversupply of money but prices of key imports. (Korner et al. p57) Handing credit allocation to private banks deprived enterprises or emerging industries from access to concessional loans, leading to economic slowdown. Finally, pushing governments to not run deficits or subsidize strategic sectors of an economy (i.e. electricity or water) had a negative effect on both the private sector and social welfare. In practice also, privatization of public enterprises such as telecommunications sometimes resulted in exploitative private-sector monopolies. It appeared the private sector was just as good at “capturing” sectors as the government.

Just as importantly, the political assumptions behind state capture, that politicians will give in to rent-seeking groups and inevitably distort economic policy, overlooked the evidence presented by the “late developers,” in East Asia, where governments had played a central role in promoting technologically-innovative industrialization through a strategic allocation of investments and
incentives to emerging sectors. (Amsden, p8-28) Dissenters to the "Washington Consensus" took this and other examples to show that the type and nature of state intervention in an economy does matter and that economic development cannot be reduced to pushing the state out of the economy (see Chang & Grabel 2004; Evans 1995; Amsden 2001). These ideas revived an interest in the politics behind economic decisions in developing countries (see Haggard et al., 1993), in the role of regulatory institutions and in the nature of relations between the state and private sector groups. These questions, both normative and theoretical, were posed not only to understand the reasons behind the success in East Asia, but also the reasons for failure: under what conditions does the state come under the influence or rent-seeking groups or coalitions, why is it "captured" or how does it come to serve the interests of those groups? Should the state be insulated from those groups?

This refocus on the type and nature of state intervention in economic policy seems not to have reached the IMF. In a report on the rise of public debts in LDCs since the Asia Crisis, the IMF devotes not a single line to analyzing the nature of public debt markets in LDCs, or the terms and conditions under which governments borrow from domestic banks or how they can influence those terms (see IMF 2003).

2.2 New Institutional Economics View

The ideas of the new institutional economists (NIEs) arose partly as a response to the deficiencies in the Neoliberal view that state intervention only undermines economic development. The new institutional economists (as their name suggests) stressed the importance of state institutions in reducing the uncertainties that exist in market transactions. In their view, as societies evolved and divisions of labor and exchanges became increasingly complex, institutions were formed to reduce "transaction costs," such as protecting property rights, enforcing contracts and protecting the rights of workers. (Bardhan, p246, Leys, p83). A key NIE assumption, taken from neoclassical economics, is that they emerged out of a need for efficiency. This has been much criticized.

---

4 Partly taking these concerns into consideration, the Bretton Woods institutions in the mid-1990s did start speaking of the importance of the state in providing regulatory mechanisms and providing public goods. However, their concept of capture and the core of the "Washington Consensus" remained the same. (see Robison & Hadiz 2004, Chang & Grabel 2004)

5 Understanding the origins of institutions in terms of efficiency creates important theoretical problems for the new institutional economists, since it would require that rational individuals pursuing their own self-interests would have
Nonetheless, NIEs understand capture as occurring in states where the institutions are either too weak or too much lacking in autonomy to enforce such rules or guarantee such rights. We can distinguish two types of capture in this view. In one case, the state can be "captured" by lobby or private sector groups that have little interest in the general welfare of society, and manipulate policy in their favor by for example acquiring state credit schemes or subsidies. Olsen has described the problem as one of "distributional coalitions" which will work to manipulate policy in their favor to gain a larger share of national income. (Haggard 1985, p509) In a more extreme case, the rent-seeking groups and policymakers are one and the same, creating a "predatory" state, one that extracts from society as much as it can without undermining its own power base. (Bardhan, p255; and also Evans 1995)

The debate around state capture in the NIE approach has revolved around different kinds of states and the nature of institutions. The ideal state for the NIEs is a "strong" state with a minimal government, with strength being defined differently by different thinkers. In the narrow sense, this can be simply a "monopoly of violence" and enforcement of contractual and property rights. (Bardhan, p253) Others stress the importance of a professional bureaucracy, autonomous from strong private sector groups, where relations with such groups are institutionalized, allowing for a continual negotiation and renegotiation of goals. (Haggard et al. 1993, p324; Evans, p30, Bardhan, p257) This latter form of a "developmental state" is inspired from an analysis of the Asian model. Weak states are the opposite of this: the most popular definition, given by Evans and Haggard et al., is that their institutions and bureaucracies are not sufficiently autonomous from important social groups, and they cannot enforce basic rights, opening the way for capture. For Bardhan, weakness is also reflected in the incapacity to commit to a particular development policy. (Bardhan, p255)

The NIEs and Neoliberals have a problem explaining the ties that are present in East Asian states between public officials and members of the private sector and imply this is a form of "capture." They cannot explain policies that while benefiting certain groups unevenly, benefit economies as a whole. Is this "capture" or a strategic collaboration between the state and its private sector groups? This has been the subject of much debate, especially following the Asia Crisis when

overcome the collective action dilemma out of some notion of the greater good of society. (see Leys, p7; Robison & Hadiz 2004)
many Western analysts found the origins of the crisis partly in these types of state-private sector linkages and "moral hazard" issues. While we cannot resolve this debate here, the problem may well lie in the NIE decision to explain the origins of state institutions in terms of efficiency or reducing "transaction costs." If we on the other hand explain institutions as "mechanisms for the allocation and consolidation of power" (Robison & Hadiz 2004) or as the "outcome of strategic distributive conflict, in which groups with disproportionate resources and power try to constrain the actions of others," (Bardhan, p263) this can radically change our view on the nature of the linkages between the state and non-state groups. Institutions in this case exist not necessarily out of some notion of efficiency but to reinforce certain power relationships in society. When seen like this, state collaboration with certain private sector or interest groups, struggles between these groups to obtain favors from the state, or an uneven allocation of state resources to some groups over others become more the norm than an anomaly. This cannot therefore be described or interpreted as capture.

This is why Bardhan, who departs from the pure NIE approach, stresses that what is important is not the fact that state policy is influenced by certain groups or favors certain groups (in other words captured for the NIEs or Neoliberals), but whether state intervention and its interaction with these groups can lead to an "encompassing" development vision. This does not take place without struggle over policy. He poses the dilemma in the following terms: "The problem is to figure out the factors that predispose a state or a political coalition to have an 'encompassing interest' in the economic performance of the country as a whole, or, to put it differently, to figure out what makes a 'strong' state." (Bardhan, p256)

### 2.3 Structural Marxist View

The understanding of the state and its institutions as reinforcing or preserving a set of power relations that emerged from past social and power struggles is central to the structural Marxist schools. What sets the Marxist approach apart from other approaches is that Marxists essentially see the state as always "captured." It is always controlled by a dominant group, class or coalition or serves the interests of those groups. The broad disagreement has been on the following: Gramscian thinkers see the state as a "factor of cohesion," distinct from the dominant classes. Its role is to organize them to ensure their domination of society in the interests of continued capital
accumulation (Jessop, p42). Its ability or success in organizing those groups is not taken for
granted. Other Marxists see the state as an “instrument” of those groups, evident in some cases
when important capitalists also hold political office. (ibid.) This debate is grounded in
disagreements among the classical Marxist writers. (Jessop, p27)

For Marxists, what differs is the nature of the capture. This is because they most often seen
capture as the result of an ongoing struggle between different capitals to influence economic and
social policy. These struggles can take place within the institutions of the state and the outcomes
can vary. For Hirsch, Holloway and Piccioto, the nature of the struggle between different capitals
(financial or industrial) to influence policy differs depends on the historical stage of capitalism.
They see the parliamentary democracy as a forum where different capitals hammer out common
rules and overcome disagreements to supervise capitalist accumulation. During later stages of
capitalism, capitalists seek to manipulate the state even more to ensure that profit rates do not
decline. (Jessop 1990) Poulantzas – a Gramscian thinker – argues that the role of the political elite
is to elaborate a national ideology that sustains the power of the dominant classes – even when
their interests diverge – while ensuring the disunity of the working classes.

Besides understanding state capture as reflective of the exploitative nature of the capitalist
system, Marxists believe that this exploitative system and all its reflections in terms of social
inequalities will only come to an end with a play of historical forces that will unite the working
classes and lead to the overthrow of the dominant classes. Until then, the state will continue to be
an “instrument” of the dominant classes or will continue to be a “factor of cohesion” organizing
those classes in the interests of capital accumulation.

2.4 Relevance

There is definitely something to be said about the importance of state institutions and strong
meritocratic bureaucracies in managing relations with important non-state groups and
preventing the worst forms of capture, whether in terms of rent-seeking or opportunistic
behavior. Intuitively, we can agree that “weak” states as defined by Evans, Bardhan and Haggard
are less capable of doing this and are more susceptible to capture. Capture can be defined in two
ways – either the state becomes an instrument of a group or coalition, which turns policy in its
favor, or a more overt form where members of a group or coalition take hold of political office. Capture of the state in these cases can be reflected in manipulations of economic policy or state credit schemes, in the formation of monopolies etc. But we should be wary of using the term capture so loosely: there is disagreement over what constitutes capture and what constitutes simply strategic partnerships between the state and private sector groups.

As we saw in the discussion, the Neoliberal and NIE approaches imply that the types of relationships seen in East Asia are actually a form of state "capture," which is why they speak so much of "rent-seeking" or "moral hazard" in these cases. However, if we are to take a more nuanced view of state-society relations, it is clear from the East Asian case as highlighted by Evans, Amsden and H-J. Chang, that the type and nature of state intervention in economies does make a difference. In such partnerships, the strategic uses of state credit schemes, and the "stick and carrot" approach to make industries more competitive, does not constitute state capture. This is particularly the case if we understand institutions, not in terms of efficiency, but as the outcome of struggles over policy and representing a certain power structure. In this case, the state collaborating with certain private sector groups, even if at the expense of efficiency, is more of a norm than an anomaly. More importantly, these partnerships are not a "capture" because the nature of the partnership, as argued by Evans and Bardhan, allows for a regular negotiation and renegotiation of goals and priorities whether through formal or informal channels. So even if state policy does favor some groups over others, this is not enough to constitute capture. The term "capture" should therefore be reserved for cases where the state loses its capacity to formulate longer-term development goals or an "encompassing" development vision, (Bardhan, p255) and when its policies are so manipulated as to generate very negative repercussions for major sectors of the economy and society.

The Marxist analysis helps in giving this more nuanced view of state-society relations particularly because it understands the state and its institutions in terms of political domination, meaning that policy will almost always favor some groups over others. It is also correct in pointing out that policy is most often the outcome of struggles between competing elite groups. This type of struggle, and the notion that the state will serve the interests of different elite groups, can be taken for granted in most states.
How can we understand the Lebanese state? Lebanon is far from having the coherent, meritocratic bureaucracy described by Evans, Bardhan and Haggard, in order to be a successful developmental state. It fits well in the definition of a "weak state" because various levels of the government – from the heads of state to the ministers and civil servants - are linked to society through informal networks that bypass the formal institutions. This is typical in Arab countries where informal networks and inter-personal relations dominate over formal channels. (see Ayubi 1995) It is also "weak" by Bardhan's definition of not committing to a development policy, and it has preferred that the private sector take the lead in economic development. (Sbaiti, p165; see also Gates 1998) But unlike the "weak" state described by our theorists above, in the Lebanese case this has not led to a "capture" of state policy. This is due to the fragmented sectarian nature of the country, which has prevented any one group from dominating; instead the system has promoted competition and compromise. Lebanese bureaucrats and politicians have traditionally handed out favors and rents to their own religious sects and constituencies, playing the role of "intermediary between state and citizen," a role of some importance in a state that has not provided much in terms of public goods. (Faris, p19) The civil service has also played a central role in mediating conflicts in this fragmented society, however they were unable to do this in the context of the political currents that swept the country in the 1970s and led to civil war. To reframe Lebanon's public debt crisis as the outcome of a capture of key state institutions, it is necessary therefore to examine the political and institutional context in the first years following the war.

---

* Lebanon has 17 official Muslim and Christian religious sects, and political power in the upper levels of government and in the parliament is divided proportionally between these sects.
3. The Makings of the Public Debt Crisis: A Critical Review

In this chapter we will look briefly at the history and nature of the Lebanon’s political economy, which is important if we are going to understand the inspiration behind the reconstruction program launched in 1993. We will then turn to look critically at the making of the public debt crisis in the context of the post-war reconstruction program as well as the attempts at crisis management by the government in the late 1990s to try and remedy the situation.

3.1 Lebanon’s political economy

Lebanon has no history of public or foreign debt. During the war in the 1980s, when government revenues collapsed, the state resorted to both borrowing and inflationary state financing, but the borrowing remained small. Through the war, Lebanon also maintained its policy of free capital and foreign exchange flows, policies that it had adopted in the 1950s in parallel with its role as a financial, banking and services center in the Middle East region. These policies had been successful in reinforcing Lebanon’s position in the region as the link between the West and oil-rich Arab states, and the country boasted largely balanced or surplus budgets, a stable exchange rate and low inflation until the war in 1975.

Lebanon has also traditionally had a non-interventionist state, with the government doing little over time to promote domestic competition or balanced development policies. (Gates, p8) The state has limited its role to providing the basic services and infrastructure necessary for private sector activity. This has made development heavily biased towards greater Beirut and created social and regional inequalities in the country. (Sbaiti, p165)

These socio-economic disparities in Lebanon exacerbated the social and political tensions that ignited the civil war. (Charif, p152) The war did serious damage to Lebanon’s infrastructure, economic base and people. Some 150,000 people were killed, thousands were displaced, and thousands of others immigrated to seek refuge in the Western countries and elsewhere. (Charif, p155) With the effective collapse of central authority in the 1980s came the development of a parallel economy focused on smuggling, trading in arms and drugs, and looting of government...
The collapse of government revenues led to inflationary state financing and widespread dollarization of the economy, something which has persisted following the war. In addition to the destruction, Lebanon emerged from the war militarily and politically dominated by its eastern neighbor Syria, while Israel occupied a "security zone" in the south.

In the post-war period, services are again dominating the economic landscape, despite pleas from many that more effort should be made to support industry and agriculture. In 1995, services accounted for 57.5 percent of GDP as much effort shifted to physical reconstruction, however by 2000 the services sector was once again accounting for 65-70% of GDP on the back of stronger tourism revenues and an increase in assets of the financial sector. The public debt and interest rate levels, as well as high production costs compared to neighboring countries, saw industry and much of the non-bank private sector struggle to stay afloat in the 1990s.

Table 1: Economic Structure, GDP Breakdown

<table>
<thead>
<tr>
<th>Sector</th>
<th>1979</th>
<th>1995 - 2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Services</td>
<td>69.5%</td>
<td>60-70%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>15.5%</td>
<td>12 - 17%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>8.5%</td>
<td>12%</td>
</tr>
<tr>
<td>Construction &amp; Mining</td>
<td>6.5%</td>
<td>10%</td>
</tr>
</tbody>
</table>


3.2 The debate around the reconstruction program

The origins of Lebanon's public debt crisis can be traced to the reconstruction program launched by the Hariri government in 1992 and the monetary and fiscal policies pursued in tandem. There is no doubt that the government faced huge challenges at the outset. Inflation in 1992 hit a very high 120 percent, with the Lebanese pound collapsing from 880 LL to the dollar at the start of the year to 1830 LL at the end, a serious blow for a country that prized itself on monetary and exchange rate stability. The reasons for this monetary deterioration are complex, but basically it was due to inflationary state financing resulting from a fiscal crisis and the inability of the central bank to defend the currency given the traditional commitment to free capital and foreign exchange movements. (Dibeh 2002, p33)
The Hariri government responded to this situation by implementing IMF-style macroeconomic stabilization policies which saw inflation brought under control the following year. These policies were also aimed at restoring Lebanon's "credibility" in international financial markets, undoubtedly something important for a country where the financial sector dominates. They included maintaining high interest rates, restrictive monetary policies, adopting a nominal anchor to the US dollar in 1992 to further control inflation, and ruling out wage increases (Economist 1997, p7; Dibeh 2000, p94) The currency gradually appreciated and stabilized at 1508 LL to the dollar in 1999, a level it has since maintained.  

In parallel with this, the government launched Horizon 2000, a 10-year rehabilitation and reconstruction plan put together with the help of Bechtel International, Dar al-Handassah, a local contracting firm, and the World Bank.  The vision behind the plan was to restore Lebanon's pre-war eminence as a services-oriented banking and business center in the Middle East. The 1993-2002 plan was divided into three phases, and the first phases included rehabilitate the business district and downtown as well as restoring basic infrastructure and public services. The reconstruction and development phases would give more attention to different parts of the country. Below is an outline of how the plan was to be financed: 50 percent from concessional foreign borrowing, 38.5 % by the government and local borrowing, and 11.5 percent from grants. (Kisirwani, p9)

<table>
<thead>
<tr>
<th>Cost</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993-1995 Rehabilitation $2.7 billion</td>
<td>Foreign borrowing 49.5%</td>
</tr>
<tr>
<td>1996-1998 Reconstruction $4.0 billion</td>
<td>Grants 11.5 %</td>
</tr>
<tr>
<td>1999-2002 Development $6.2 billion</td>
<td>Government &amp; Domestic Borrowing 38.5%</td>
</tr>
<tr>
<td>Total: $12.9 billion</td>
<td></td>
</tr>
</tbody>
</table>

---

8 The Economist, Country Profile, 2000, p54.
9 These provided consulting services to assess the damage to infrastructure and assess the financing requirement for the reconstruction program.
10 Taken from Kisirwani, p9.
Parliament decided in 1994 to not adopt Horizon 2000 but to approve it on a project basis, therefore this is only a rough outline. It was revised several times to take into account domestic and international developments. A more recent version covers the period 1995 to 2007, and has a financing requirement of $17.8 billion (1995 prices). (UNDP 1997, p17)

Hariri justified the swift launching of the plan through high domestic borrowing, arguing that the options of waiting for foreign aid, or massively raising taxes, would have led the country into recession. This plan would in a much shorter time create an environment “conducive to capital inflows and investment” and was the “only strategy that would have led to an appreciation of assets in Lebanon, thereby raising markedly the wealth of the Lebanese.” He also said policies would be favorable to the private sector. The prime minister recognized that high public debt “was a natural consequence of spending on reconstruction and on social needs, as well as military and security spending in a post-war economy. However, this should not present insurmountable obstacles as long as the economy continues to grow and the capacity to finance these deficits remains strong.”

The Hariri government cannot be criticized for wanting to finance the reconstruction plan through domestic borrowing. In fact, Lebanon was fortunate to have a large and experienced banking sector and a strong reserve base to fund post-war reconstruction. As noted by Addison et al., one of the main challenges for post-conflict countries when they embark on reconstruction is restoring their banking systems and capital markets, and developing a market for public debt. The latter is important in order to prevent inflationary state financing. (Addison et al., p7-10) Given Lebanon’s advantages in these domains, it was not in any way strange to turn to domestic borrowing. Secondly, following a destructive conflict, it is only rational for a government to take the initiative to revive the economy, as was done in Europe following the Second World War, following the Keynesian approach of running budget deficits to create employment, raise output and in the long-run, increase savings.

The problem was not with the reconstruction plan *per se*, but the policy options that went in tandem with it that can be blamed to a significant extent on the Neoliberal ideology guiding the government. Firstly, in spite of planned increases in government spending, the tax code was "simplified" by the Hariri government. The maximum tax on individual earnings and corporate profits was reduced to 10 percent in 1993, and tax holidays were given to new investors, the purpose being to attract investment. "This combination of large expenditures and low taxes led to a continuous widening of the budget deficit and hence the accumulation of debt." (Dibeh 2000, p95) The Hariri government at several points turned to indirect taxes (i.e. on goods and services) to boost revenues, but these taxes hit the poorest segments of the population hardest. Interestingly, at no point were taxes levied on financial transactions or interest-bearing instruments.\(^{11}\) (ibid.) Subsequently, analysts questioned the rational behind these policies. For the period 1992 – 1998, the height of reconstruction spending, Lebanon's revenues/GDP ratio averaged 16 percent. By comparison, Jordan's average in 2000 was 25 percent and Tunisia 29, both countries not launching reconstruction programs.\(^{12}\) In terms of tax distribution, Lebanon has one of the lowest average direct taxes (on incomes and profits) in the Middle East – this is also compared to 42 percent in the European Union and 55 percent in the United States. Customs duties, have traditionally accounted for the majority of revenues.

### Table 3: Distribution of Tax Revenues in Percentage for Select Middle Eastern Countries

<table>
<thead>
<tr>
<th></th>
<th>Direct taxes</th>
<th>Indirect taxes</th>
<th>Customs</th>
<th>Other indirect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jordan</td>
<td>20</td>
<td>43.3</td>
<td>34.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Lebanon</td>
<td>18.6</td>
<td>43.3</td>
<td>59.1</td>
<td>4.1</td>
</tr>
<tr>
<td>Tunisia</td>
<td>19.2</td>
<td>27.5</td>
<td>30.6</td>
<td>22.7</td>
</tr>
<tr>
<td>Turkey</td>
<td>39.9</td>
<td>39.7</td>
<td>17.9</td>
<td>2.5</td>
</tr>
<tr>
<td>Morocco</td>
<td>27.1</td>
<td>52</td>
<td>19.5</td>
<td>1.4</td>
</tr>
</tbody>
</table>


The Lebanese central bank began in May 1993 weekly auctions of three, six, 12 and 24 months securities, which given the high interest rates were readily bought by local commercial banks and private investors. The maintenance of high rates through the 1990s was a second major factor in the making of the debt crisis, because it worsened the debt servicing burden. We will discuss the issue of interest rates, which has raised serious questions, in Chapter 4. As of 1994, the government also began issuing foreign currency debt in the form of Eurobonds, which carried

---


lower yields than the treasury bills. These T-bills and Eurobonds were issued to cover the government’s growing deficits, which over the period 1992-2002 averaged $2.3 billion per year, with an ever-growing percentage of expenditure going towards debt servicing (see Table 4). However, the foreign currency component of the debt remained small until the year 2000, when the government increasingly started relying on foreign-currency debt.

Table 4: Lebanese Government Annual Deficits 1992-2002 (in Billion LL)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>1138</td>
<td>1855</td>
<td>2241</td>
<td>3033</td>
<td>3536</td>
<td>3752</td>
<td>4429</td>
<td>4868</td>
<td>4553</td>
<td>4650</td>
<td>5398</td>
</tr>
<tr>
<td>Expenditure</td>
<td>2219</td>
<td>3017</td>
<td>5204</td>
<td>5856</td>
<td>7245</td>
<td>9161</td>
<td>7906</td>
<td>8454</td>
<td>10424</td>
<td>8878</td>
<td>10138</td>
</tr>
<tr>
<td>o/w debt service (%)</td>
<td>23.3%</td>
<td>26.0%</td>
<td>28.6%</td>
<td>32.0%</td>
<td>37.2%</td>
<td>36.9%</td>
<td>41.7%</td>
<td>42.9%</td>
<td>40.3%</td>
<td>48.4%</td>
<td>45.6%</td>
</tr>
<tr>
<td>Deficit</td>
<td>-1081</td>
<td>-1162</td>
<td>-2963</td>
<td>-2823</td>
<td>-3709</td>
<td>-5409</td>
<td>-3477</td>
<td>-3586</td>
<td>-5871</td>
<td>-4228</td>
<td>-4740</td>
</tr>
<tr>
<td>Deficit (US bn)</td>
<td>-0.61</td>
<td>-0.66</td>
<td>-1.88</td>
<td>-1.88</td>
<td>-2.47</td>
<td>-3.61</td>
<td>-2.32</td>
<td>-2.39</td>
<td>-3.91</td>
<td>-2.82</td>
<td>-3.16</td>
</tr>
<tr>
<td>Deficit/GDP</td>
<td>-11.4%</td>
<td>-8.9%</td>
<td>-19.7%</td>
<td>-15.7%</td>
<td>-18.2%</td>
<td>-23.5%</td>
<td>-13.7%</td>
<td>-14.3%</td>
<td>-23.7%</td>
<td>-17.3%</td>
<td>-18.5%</td>
</tr>
</tbody>
</table>


The public debt grew from the equivalent of $4.1 billion in 1993 to $8 billion in 1995 and $25.1 billion in the year 2000. The debt crossed the red line of 100 percent of GDP in 1997, and by 2004 reached 185 percent of GDP, amounting to $35 billion. The foreign currency component only amounted to 28 percent of the total in 2000, but was up to 51 percent in 2004. (Iskandar, p50)

It is interesting to note in passing that GDP growth closely followed government capital expenditures (that is, spending on reconstruction and development), confirming the positive effect of expansionary policies in the early 1990s as investments went into reconstruction and development (see Chart 2). The strong capital expenditure between 1992 and 1997, averaging 36 percent of total revenues, was the main motor behind economic growth. Real GDP growth peaked at 8 percent in 1994. However, as debt servicing continued to rise, peaking at 92 percent of revenues in 2000, the country went into recession with negative growth. The high debt servicing burden, averaging 74.7 percent of total government revenues over the 1992-2002 period, effectively "crowded out" private investment as lending to the government kept interest rates high.

---

14 Figures compiled from Economist Country Reports and Ministry of Finance.
A similar picture emerges when we look at the debt crisis from the perspective of expenditures (see Chart 3). After an initial surge in capital expenditure, reaching 25 percent of total expenditure in 1996, capital expenditure declined to reach 9 percent of total expenditures in 2000. During the 1992–2004 period, debt servicing absorbed 40 percent of all government expenditure while capital expenditure accounted for only 13 percent. This means Lebanon had to rely increasingly on foreign grants and funding for its reconstruction.
Towards the end of the decade, Lebanese became increasingly unhappy at the Neoliberal agenda behind the reconstruction program, which gave priority to macroeconomic stability over equitable development and addressing social and regional inequalities. The productive sector suffered from these fiscal policies and high interest rates, especially because no efforts were made to create positive linkages between the financial sector and the productive sector. (El Chaziri 2005, p72) It is significant that emigration, the age-old Lebanese solution to economic hardship, continued at an alarming pace throughout the 1990s. We will look at the impact on the productive sector in chapter 6.

For Ghassan Dibeh the problem is in part due to the “Neoliberal-monetarist" ideology guiding the government. A Neoliberal stabilization package of lower taxes, high interest rates and restrictive monetary policy was combined with fiscal expansion to fund the reconstruction. These led to an uncontrollable expansion of debt and an exchange rate appreciation:

“This policy was similar to the Reagan administration’s disinflationary policies of the 1980s. Restrictive monetary policy led to disinflation, while expansionary fiscal policy led to the mitigating
of the adverse effects of monetary policy on output at the expense of higher local and foreign debt.”
(Dibeh 2000, p95)

3.3 Crisis Management and the Foreign Debt

Entering a major fiscal crisis in 1997-8, when debt servicing was swallowing 90 percent of government revenues, the Hariri government responded by relying increasingly on foreign-currency debt (mainly Eurobonds) which had longer maturities and lower yields, and swapping local for foreign currency debt. (The Economist, Country Profile 2003) These policies account for the rise in the foreign currency-component of the debt, which in 1997 had amounted to only 15.8 percent ($2.4 billion) of the total debt. Concern over the fiscal situation pushed Hariri to cut back capital expenditure in 1998 and to raise taxes. (Baroudi, p65) These measures reduced the budget deficit in 1998 to 13.7 percent of GDP, from 23.5 percent the year before. (see Table 4) The government also turned to its foreign creditors for a rescue package. However, despite the advantages of taking on foreign currency debt, the government was making the country more vulnerable to crisis. A debt default would also entail a currency and balance of payments crisis, and would require major adjustment policies, including devaluation, as happened in Latin America in the 1980s. (Dibeh 2000, p96)

Yields on Eurobonds have been substantially lower than those on T-bills, giving the government a little more breathing space. The average yield on Eurobonds in the 1990s was 10 – 12 percent (excluding average 4 percent inflation over the period.)

In November 2002, the Hariri government met with its main creditors and donors in Paris, with the aim of securing long-term concessional funds to refinance a part of Lebanon’s debt and to bring down interest rates.19 At this conference, Lebanon received a financial package totaling $10.6 billion, allowed debt servicing costs to fall significantly. It resulted in $1.8 billion of debt being cancelled, $2.7 billion debt exchanged prior to maturity, and $5.6 billion principle and interest repaid or rolled over at maturity. In return, Lebanon’s creditors asked for serious steps to be taken in the areas of privatization and public sector reforms.

The government saw the conference as a stamp of approval in the Lebanese economy, and the receipt of the concessional finance had a positive impact on interest rates. Rates on treasury bills, which are the benchmark rate in Lebanon, declined by almost 50% one year following Paris II (see Table 5), and yields on Eurobonds also declined slightly (see Chart 4).

The gains of Paris II, coupled with tax reforms and improved revenue collection, meant that in 2004 debt servicing dropped to account for 53.5% of government revenue. Despite this improvement, The Economist country report for 2004 judged that “the outlook for government finances remains precarious and fiscal issues will continue to dominate policymaking, limiting the government’s scope to adopt more growth-oriented measures.” The report added that to break the debt cycle, Lebanon needs capital generating measures coupled with strong growth, and further increases in revenue and cuts in spending, “a difficult balancing act for which it will be hard to build political support.” (The Economist 2004, p28)

Table 5: Evolution of Nominal Interest Rates pre-, post-Parse II

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>3-month TB</td>
<td>11.18 %</td>
<td>6.96 %</td>
<td>5.37 %</td>
</tr>
<tr>
<td>24-month TB</td>
<td>14.64 %</td>
<td>9.41 %</td>
<td>7.84 %</td>
</tr>
</tbody>
</table>


Chart 4: Select Eurobond Yields

Yields on Selected 10-year Eurobonds versus US Average

Source: Lebanese Central Bank.
4. Capture: The Economic Context

In this section, we will address the question on whether Lebanon’s public debt crisis was the result of a capture of the state. In looking at the economic aspect, the question we ask is whether we can find evidence of manipulation of state fiscal and monetary policy. What effect have these policies had on the financial sector and on industrial groups? Whom have these policies benefited?

When one considers the figures, there is no doubt that the banking sector has been the main gainer of state fiscal and monetary policy. According to the sources, in 2004 the local commercial banks held 46.3 percent of the government’s local currency debt, the central bank 40 percent, and the remaining 13.3 percent was held by the public and public institutions. (Iskandar 2004, p50) As for the foreign currency denominated debt, some 80 percent is held by local commercial banks, while only 9.8 percent is held by foreign governments and agencies. (The Economist, country profiles)

Evidence of manipulation of policy can be found when one looks at the structure of interest rates on government borrowing over the period, commercial bank deposit and lending rates and the management of the treasury bill market. Critics have argued that the policies of the Hariri government have essentially subsidized the activities of the country’s 63 private banks at the expense of the rest of the economy. This is also reflected in the weak linkage between the significant assets of the financial sector and the productive sectors of the economy. Despite talk of allowing the private sector to lead the post-war recovery, the non-bank private sector has instead become its casualty.

---

16 In 2003, the figure was 33 percent. The commercial banks have decreased their buying of local currency debt and have preferred Eurobonds. This may well be because of the lower interest rates since Paris II, and perceptions of risk in holding local-currency debt. The central bank’s holding of government debt has not been inflationary so far because this is offset by 1) the central bank requirement that commercial banks deposit with it 15 percent of their foreign currency assets 2) the large capital base of Lebanon.

17 Of the 63 banks, 10 are investment banks, and all are local Lebanese banks. Several of the large banks have branches abroad in neighboring Arab states and in Europe. For a population of only 4 million people, this is a testimony to the importance of this sector in the country.
4.1 Treasury Bill Rates

We focus on Treasury Bill rates because local currency debt was the main factor in the making of the public debt crisis in the 1990s. The foreign currency component of the debt was only 28 percent of the total in 2000, but grew significantly after that following an official policy of debt-swap and increased reliance on foreign-currency debt. Treasury bill rates are important because they are the base interest rate in the country, setting the basis for the determination of deposit and lending rates of the commercial banks.

That interest rates were high in May 1993, when the government issued its first Treasury Bill, is understandable. The year before had seen high inflation, a collapse of the Lebanese pound against the dollar, and practically empty government coffers. But as the 1990s progressed, interest rates on government borrowing remained high, inflating state debt servicing and crowding out the private sector. “It is true that Lebanon’s credit worthiness was not high after the war, but borrowing at rates that were significantly higher than the prevailing rates on dollar accounts, given a reasonable risk premium, is not defensible,” wrote economist Atif Kubursi in 1999. (Kubursi, p80)

The average yield on 3-month treasury bills from 1993-1998, in real terms, was 13.2 percent and in nominal terms 15.7 percent. (The nominal return on a 24-month T-bill from 1993-1998 was 20.3 percent) However, it is necessary to point out that the difference between the nominal and the real rates was largely irrelevant, and that the nominal rate was in fact the real rate. The reason is the nominal Lira anchor to the dollar in 1992, with the exchange rate guaranteed by the central bank, combined with the gradual appreciation of the Lira from 1993 – 1999, which saw the Lira go from LL 1741: $1 to stabilize at LL 1508: $1 in 1999, a level it has since maintained. Needless to say the appreciations were an extra bonus to the commercial banks that were holding the majority of the government’s debt. In Chart 5, I have included the Libor rate, to give an idea of the risk premiums offered over that base international rate.
Table 6: Average Interest Rates on 3 month Treasury Bills 1993 - 2002

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal</td>
<td>15.7</td>
<td>14.0</td>
</tr>
<tr>
<td>Real 14</td>
<td>13.2</td>
<td>13.7</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance.

Chart 5

The question we must ask is were these interest rates justified given currency and exchange rate risk? The central bank repeatedly said the high interest rates in the 1990s were needed to reduce inflation, boost Lira reserves and because of perceived political risk in the region. (Economist 2000, p34) However, as argued by George Corm, where is the evidence for this currency and exchange rate risk? At their lowest in 1993, central bank foreign reserves, excluding gold, covered 5.4 months of imports - worry is usually expressed only when reserves fall below covering 3 months of imports (see Table 7). This is not to discount the importance of political factors, but it is interesting that the one time when reserves did fall significantly was between 1999 to 2000 due to

---

14 Real interest rates were calculated by factoring in the effects of consumer price inflation as well as the currency appreciations from 1993 – 1999. The disinflationary monetary policy of the government discussed earlier caused this strange combination of currency appreciation and inflation, which to some extent cancel each other out and explain the close correlation between the two rates.
concern over government fiscal deficits and not regional instability. The central bank stepped in at the time to defend the currency peg, depleting reserves. This happened from 1999 to 2000 when there was concern over fiscal deficits. (The Economist 2001, p34)


<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserves</td>
<td>2.22</td>
<td>3.84</td>
<td>4.53</td>
<td>5.93</td>
<td>5.97</td>
<td>6.55</td>
<td>7.77</td>
<td>5.94</td>
<td>5.01</td>
<td>7.24</td>
<td>11.09</td>
<td>12.31</td>
</tr>
<tr>
<td>Mts of imports</td>
<td>5.4</td>
<td>7.7</td>
<td>7.4</td>
<td>9.4</td>
<td>9.6</td>
<td>11.1</td>
<td>15.0</td>
<td>11.4</td>
<td>8.2</td>
<td>13.5</td>
<td>18.6</td>
<td>16.2</td>
</tr>
</tbody>
</table>


For economist T. Gaspard, the problem is that T-bill rates have not determined by market forces, as is claimed by the central bank, but by unofficial understandings between the central bank and the Association of Lebanese Banks (ALB), a grouping of the major commercial banks in the country. “This situation is facilitated by the oligopolistic structure of the banking industry, where the largest five banks averaged about 45% of total deposits…” (Gaspard, p218) Evidence of these practices were also noted by S. Andary and S. Hakim in their study of the Lebanese T-bill market. In 1994, the central bank raised interest rates when the Hariri government threatened to resign, to prevent a run on the Lira and a dumping of treasury bills. However, when the crisis defused in 1995 interest rates did not budge (see Chart 5) even while the demand relative to supply of T-bills registered its highest level. (Andary & Hakim, p238)

Andary & Hakim say one explanation for this is the way auctions are managed. The central bank, on the pretext of relieving foreign buyers from participation at auctions and compensating them for exchange rate risk, honors all the requests of foreign investors for T-bills by purchasing them on their behalf at yields that are the average for what is on offer. This has resulted in a massive subscription to T-bills by foreigners, who are shielded from competing at auctions by this policy. As a result, funds the government has no need for have been borrowed at high rates.

Gaspard, for his part, estimates that at least half of the interest costs on Lira borrowing from 1993 to 2002 “was paid in excess of what the cost would have been in a normally operating market. As the weighted average interest rate of Lira-TBs has been about 9 percent since early 2003, this rate reasonably and conservatively may be taken as a representative Lira-borrowing rate by government during 1993-2002.” This is particularly the case since the economic situation was
markedly better in the early 1990s than in 2002. (Gaspard, p218) He estimates the government could have saved $8.5 billion in interest costs on its Lira borrowing had this been the case.

4.2 Performance and Practices of the Commercial Banks

In its 1994 report the central bank argued that the high interest rates were necessary because private investment would not have taken off and these ensured funding was available for the government to go ahead with reconstruction plans. Undoubtedly, the commercial banks have been more than happy to lend to the government on these terms, and have reaped massive profits doing so. What we see in Lebanon in the post-war period therefore is a rapid increase in the consolidated assets of the commercial banks, from $14.5 billion in 1994 to $52.4 billion in 2002, equivalent to 308 percent of GDP. Moreover, 60-70 percent of these assets are in US-dollars.19

Table 8: Consolidated Assets of Lebanese Commercial Banks 1994 - 2003

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Assets (LL)</th>
<th>Total Assets in US $ bn</th>
<th>as % GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>24,285</td>
<td>14.5</td>
<td>161%</td>
</tr>
<tr>
<td>1995</td>
<td>29,055</td>
<td>17.9</td>
<td>161%</td>
</tr>
<tr>
<td>1996</td>
<td>37,183</td>
<td>23.7</td>
<td>182%</td>
</tr>
<tr>
<td>1997</td>
<td>45,633</td>
<td>29.7</td>
<td>198%</td>
</tr>
<tr>
<td>1998</td>
<td>55,031</td>
<td>36.3</td>
<td>217%</td>
</tr>
<tr>
<td>1999</td>
<td>60,971</td>
<td>40.4</td>
<td>243%</td>
</tr>
<tr>
<td>2000</td>
<td>67,888</td>
<td>45.0</td>
<td>274%</td>
</tr>
<tr>
<td>2001</td>
<td>71,855</td>
<td>47.6</td>
<td>295%</td>
</tr>
<tr>
<td>2002</td>
<td>79,065</td>
<td>52.4</td>
<td>308%</td>
</tr>
<tr>
<td>2003</td>
<td>84,170</td>
<td>55.8</td>
<td>310%</td>
</tr>
</tbody>
</table>

Source: The Economist, Country Profile, various issues.

An estimated 52 percent of all commercial bank investments were in government securities in 2005.20 Deposits have been the major source of funds for the banks, representing 82 percent of their resources in 2003. Eighty-two percent of these are deposits from the resident private sector, 15.6 percent are deposits from non-residents and 1.8 percent from the public sector. (Iskandar, 2004)

Lebanon's commercial banks have had a comfortable ride in the 1990s lending to the government. Thanks to dual interest rates, banks have offered depositors an average rate of 5-6 percent on their dollar deposits, the majority of accounts in the country, and around 13 percent (1993-2000

19 Within 6 weeks of the assassination of Prime Minister Rafiq Hariri, the dollarization rate jumped to 81 percent. (Iskandar 2004, p126)
nominal averages) on Lira deposits. In the meantime, they have re-invested in government treasury bills with nominal yields for the period 1993 – 1998 averaging 15 percent for 3 month bills and 20 percent for 24-month bills, knowing the exchange rate peg is guaranteed by the central bank. Moreover, from 1994 to mid-1997, the central bank encouraged these practices, requiring commercial banks to invest 40 percent of all their Lira assets in treasury bills. (The Economist, 1997, p28) It is also important to recall that from 1993 – 2000 the majority of lending to the government was in Lira, the foreign component reached 28 percent in 2000. Commenting on the dual interest rate structure and manipulations in the T-bill market, Corm writes that “banking profits are fine, as long as they originate from real economic growth and entrepreneurial dynamism. When their exclusive source comes from over-borrowing the treasury and charging both the public and private sectors unrealistically high interest rates, these profits become a killer for the economy.” (Corm 2003, p5)

Yet the question arises of why the ruling elite manipulated policy and drained the state of funds in favor of the banking sector? We find two answers to this question. On the one hand, there are the close linkages between the politico-business elite and the banking sector. Many owned important shares in this sector, while the prime minister himself also owned one of Lebanon’s largest banks, Groupe Méditerranée. But there are also the needs of the banking sector itself, which emerged from the war with many banks in a bad financial position. Many had small capital bases, were organizationally inefficient and technologically weak (Andary & Hakim, p235) and so the option of high yielding government debt was one way of staying in business. As for the larger banks, they also needed somewhere to invest their substantial resources, having lost their international operations and reputations during the war. The fact remains that the same linkages that drained the state of its resources could have been used by the politico-business elite to obtain concessional funds for the state, and moderate the levels of debt.

Needless to say the effects of these policies, especially on the productive sector and on the housing market, have been really bad. In part this is because most investments are going to the government, in part because residents have no where else to go, banks have felt free maintain lending rates “close to usury.” (Hakim & Andary, p236) This can change if more foreign banks

---

22 This was confirmed in an interview with a member of Association of Lebanese Banks, Elie Ashkar, who said that government debt was a good option for the banks because they needed somewhere to invest their resources.
enter the market, but their incentives to enter such a small market are clearly low. In Table 9 we compare lending rates (nominal and real), which have gradually declined since the 1990s.

Table 9: Commercial Bank lending rates (annual averages)

<table>
<thead>
<tr>
<th></th>
<th>1996</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollar</td>
<td>Nom.</td>
<td>11.9%</td>
</tr>
<tr>
<td></td>
<td>Real</td>
<td>6.2%</td>
</tr>
<tr>
<td>Lira</td>
<td>Nom.</td>
<td>24.7%</td>
</tr>
<tr>
<td></td>
<td>Real</td>
<td>18.8%</td>
</tr>
</tbody>
</table>

Source: Central Bank, available at www.bdl.gov.lb

In the housing sector this has meant mortgage loans are practically impossible to obtain. This has left a large number of buyers without credit, and a large stock of unsold apartments. Owners of housing projects are in no rush to sell because many projects are built from their own capital, not from borrowed funds. Prices in fact rose by 250 to 300 percent in dollar terms during the 1990s, as part of a general trend of real estate speculation. (ibid)

It is striking to see how similar the symptoms faced by the Lebanese economy are to those seen in countries that have implemented structural adjustment programs. The effects of controlling money supply, restricting credit (except to government) through high interest rates, tax cuts (to encourage investment), caps on wage increases, and other deflationary policies. This restrictive monetary policy is adopted to cut domestic demand, which "monetarists" believe is responsible for causing inflation. (Komer et al., p57) This tends to overlook the reasons for inflation in countries like Lebanon, which is usually more related to high-import bills especially of essential commodities. The consequences of these policies in Lebanon and many other developing countries have led in some cases to severe deflation and recession. Inflation in Lebanon for the 1998 – 2002 period was a mere 1.3 percent. Investments have shifted to non-tradables, especially the real estate sector, where speculative bubbles can quickly develop. High interest rates also unnecessarily burden government finances. The other cornerstone of these stabilization

---

23 Inflation and appreciation of Lira factored in. There are no separate indicators for dollar consumer price inflation in Lebanon, but with the currency peg both rates are affected equally. The Lira appreciated against the dollar from LL 1741 in 1993 to stabilize at LL 1508 in 1999.

packages, liberalizing trade and capital transfers, does not apply in Lebanon which already had liberal trade and capital flow regimes.

Despite these repercussions, G. Dibeh expressed surprise in 2000 there was no serious rethink of guiding economic ideology. The central bank was proud of the achievement of the reported zero inflation in 1999:

"The problem lies not in the figure but in the interpretation. This is hailed as a triumph for monetary policy. Of course, any able-minded economist knows that zero inflation means that a drastic disinflation has occurred with great costs in unemployment and lost output. If the figure is true, we need to congratulate the monetary authorities for presiding over one of the severest deflationary episodes in the capitalist world since the Great Depression in 1929." (Dibeh 2000, p99)
5. Capture: the Political and Institutional Context

In the previous section, we showed how the Hariri government manipulated post-war fiscal and monetary policies in favor of the financial sector. The oligopolistic practices of the central bank and commercial banks and the manipulation of interest rates and of Treasury Bill markets essentially drained the government of funds that could have been used for other purposes. This contributed directly to the accumulation of an unsustainable public debt.

However, our story is not complete without asking questions about the political and institutional context in which key institutions of the state were captured and these policies were formulated. It was after all political actors that were formulating economic policy. We turn therefore to the following questions:

- What was the political and institutional context in which this capture occurred?
- How can we understand the capture theoretically?

The rise of the politico-business elite in the Hariri government in Lebanon must be seen in the light of the unique political and institutional context of the post-war period. The main elements defining this new context were: 1) political domination by Syria, which now kept a close watch on government appointments 2) the diminished capacities of the bureaucracy and the line ministries following 15-years of war 3) a shift in political power from the appointed president to the prime minister and his cabinet arising out of the 1990 Taef Peace Accord. The latter point is significant in that candidates could now win widespread political support for their parties before elections by mobilizing their own resources. Hariri, with his multi-million dollar portfolio, had a major advantage in this area. He also became Lebanon’s longest-serving prime minister. Between 1992 and 2004 he was out of office for only two years, 1998 – 2000, and for most of the time held both the posts of prime minister and finance minister.

Concerns about the nature of the new government were expressed early on. Norton and Schwedler wrote in 1992 that “there are fears that Hariri will treat Lebanon like a business acquisition, and simply add the country to his hefty portfolio.” To a large extent, this is what subsequently happened. Following the 1992 elections, 20 of the 30 members of Hariri’s cabinet

---
25 The premises of many ministries were destroyed in the conflict.
were newcomers to politics. (Norton & Schwedler, p52) With the state largely weakened following war, and many ministries and services simply dysfunctional, the prime minister brought his own men and know-how to the task of rebuilding Lebanon. The central bank was given to Riad Salameh, formerly in charge of Hariri’s portfolio at Merrill Lynch. The finance ministry was handed to Fuad Seniora, a former employee at Citibank, who held various positions in Hariri’s enterprises including chairmanship of Groupe Méditerranée. The governorship of Mount Lebanon was given to Suhail Yamut, former director of Hariri’s business interests in Brazil. Farid Makari, vice president of Hariri’s contracting company Saudi Oger later became information minster. 26 From the outset, the government was characterized by a major overlap of public and private interests.

The prime minister also preferred to advance his reconstruction program outside the framework of traditional state institutions. One of the main reasons for this is simply pragmatism. These traditional institutions, leaving aside their dysfunctional inefficient state, would have been impossible to work with given the rivalries between various militia-political leaders that were re-integrated into the government following the war and the fragmented nature of Lebanese politics. In a celebrated article published in 1998 in Middle East Policy, G. Denoeux and R. Springborg have described the relationship between Hariri’s government and the traditional war time leaders as a “two-sided” Lebanese state.

“[I]nstead of modernizing the state and then relying on it to implement his reconstruction model, he simply decided to leave the existing state more or less in place, and proceeded to carry out his reconstruction strategy by mobilizing his own team, recruited from his business empire.” (Denoeux & Springborg, p4.)

It was in this context, largely outside the framework of traditional state institutions and with Syria’s tacit approval, that monetary and fiscal policy were manipulated to favor the banking and financial sector, reflective in the rapid accumulation of government debt, which among other things, funded the post-war reconstruction as well as bolstering the private portfolios of the politico-business elite and the banking sector. This overlap of interests stretched to other areas as well, such as the contracting out of projects.

The Council for Development and Reconstruction (CDR), another institution captured by the politico-business elite, awarded Solidère -- the joint-stock contracting company in which Hariri was the major shareholder -- the lucrative contract for re-building Beirut's central district. The Hariri government in many cases capitalized on the CDR, which, as a "super-ministry" could effectively bypass the regular ministries and provide electricity, water and basic services. CDR was set up by the government in 1977 to oversee the reconstruction of war-damaged infrastructure and to lobby for foreign funding. Given the situation at the time, it was given unprecedented powers to plan and execute infrastructure projects and to obtain foreign funds. Government funding for reconstruction of central Beirut was therefore going directly to the private portfolio of the prime minister. Not surprisingly, Lebanon's first Eurobond issue of $400 million in October 1994 was also managed by Merrill Lynch.

One would question whether the manipulation of fiscal and monetary policies would have been effectively challenged had there been strong lobbies in the industrial or productive sectors. To be sure, the government had a troubled relationship with the Association of Lebanese Industrialists and the labor unions, which regularly protested against these policies. (Baroudi 2002, p64) However, given the traditional predominance of the financial sector and the make-up of the government, these groups were unable to change the direction of policy or the guiding ideology. To some extent, the politico-business elite can be likened to M. Olsen's "distributional coalitions" that in times of economic transition lobby or struggle to turn policy in their favor. In this case however, the coalition and policymakers were one and the same.

5.1 Syria and its allies

Hariri's time was characterized by coexistence, mostly collaborative but sometimes uneasy, between the politico-business elites and the traditional wartime leaders, among them allies of Syria. Though Syria supported Hariri's reconstruction plans, because a wealthier and more stable Lebanon suited its interests, Syria also played a classic balance of power game, playing different sides off each other and -- though the details are obscure -- taking its share of rents from the Lebanese state.

Interview with Dunia Qabbani, CDR.
Foremost among Syria's supporters has been the Lebanese president, and through the 1990s it always ensured its preferred candidate was appointed to the post. With the Taef Accord, the president's role became largely ceremonial, although he remained the head of the armed forces and was responsible for ensuring the proper functioning of government, the prime minister was now the most important figure in the government. However, Syria's policy was to never allow a single Lebanese actor to dominate and so to some extent it constrained Hariri to focus on economic issues. (Denoeux & Springborg, p5) Therefore, the politico-business elite never captured the entire state, and like any prime minister, Hariri had to face the usual opposition to policies aimed at for example cutting ministerial budgets or privatizing state sectors from rival interests.

One of the best documented cases of Syria entering the rent-seeking game is that of the mobile phones sector. The network was contracted out to two private companies in 1994, with the government receiving 50 percent of all revenues. LibanCell was 85% owned by the sons of former defense minister Mohsen Dalloul, a figure close to prime minister Rafiq Hariri, but also someone with links also to Syria's ruling elite. Cellis came to owned 30% by a figure close to the late Syrian President Hafez al-Assad, public works and transport minister Najib Maqati. Under the Hariri government, both companies apparently understated their revenues and violated contract terms, but the Hariri government looked the other way.

With the coming of the Selim Hoss administration in 1998, the new government accused the companies of various violations including vastly understating revenues and imposed a $300 million fine on each of them. However, both companies refused to pay, relying on the fact that their Syrian backers that were receiving a part of the profits would prevent the government from taking action against them. In June 2001, with Hariri back in power, the government announced it would cancel the contracts given to LibanCell and Cellis, which still had three years before they expired. Hariri insisted both companies would be compensated for this cancellation, while President Emile Lahoud and the new telecoms minister Jean-Louis Qordahi, an ally of Lahoud and both allies of Syria, were against the compensation, which would go indirectly to members of Hariri's network. The issue was eventually was taken before the courts in France. 28

---

28 This summary of the conflict over the mobile networks is taken from Gambill, G.C., "Lebanon's Cell Phone Scandals," in Middle East Intelligence Bulletin, Vol. 5, No 1, Jan, 2003.
This clash of interests sheds light on the murky back-dealings that took place during Syria’s dominance of Lebanon, and its relationships with various Lebanese figures in the political and economic realms. Little is known about the extent or nature of these dealings or how they are linked to Hariri’s death, except that he had enemies both in Lebanon and Syria. However, what is known is that Hariri’s resignation in October 2004 was motivated by his frustration at Syria’s interference in Lebanon (he became increasingly critical of Syria towards the end of his term) and his desire to pursue a more independent path. Most Lebanese believe that this fall out with Syria was the main reason for his assassination in February 2005, which they suspect was ordered and planned by Syria. 29

5.2 The Challenge of the Selim Hoss Administration 1998 - 2000

Mounting dissatisfaction with the economic policies of the Hariri government, including the high public debt, and the deterioration of major economic and social indicators, led the prime minister to resign in November 1998. The new government under prime minister Selim Hoss pledged to give priority to redressing the budget deficit and bringing down the public debt through austerity measures. (Baroudi, p69) The new government introduced a value-added tax, and raised the maximum tax rate on income and corporate revenues from 10 percent to 20 percent, and the corporate tax on profits from 10 to 15 percent. (Baroudi, p70) These measures were all part of plans to increase government revenues from 16 to 23 percent of GDP, and to “distribute the burdens of adjustment more fairly.” (ibid., p79) Only a moderate rise was achieved however. Various indirect taxes were also maintained or raised.

Both Hoss and his finance minister Georges Corm were avid critics of the Hariri government’s Neoliberal policies. However, they inherited an economic situation that was dire, and ended up pursuing many of the same policies as the Hariri government, including foreign borrowing.30 The new government managed to hold the budget deficit to 1998 levels, at 14 percent of GDP, as opposed to the 24.5 percent of 1997 (see table 4). However, with the weight of the debt and the recessionary environment, the deficit shot up again in 2000 to 23 percent of GDP. Hoss and Corm also tried to push the banking sector to reduce interest rates, which were lowered grudgingly.

29 Hariri was assassinated on February 14, 2005, when his motorcade in Beirut was bombed, killing 22 other people. The assassination set off a wave of anti-Syrian demonstrations in Lebanon, and an increase in US and EU pressure on Syria, which resulted in a withdrawal of all Syrian troops from Lebanon in April.
30 To cover the budget deficit, parliament approved in 1999 the issuing of $2 billion in Eurobonds.
The two also improved embittered relations with labor, initially by raising public sector wages by 30 percent. (Baroudi, p75) However, relations deteriorated again when the government refused to meet various long-standing demands, such as a lowering indirect taxes, especially on fuel and other commodities. Given the fiscal position, policymakers were forced to “act with their heads and not their hearts.” (Ibid.) It became clear a few months after taking office that the Hoss administration could do little beyond damage control.

In this chapter we have sought to understand the political and institutional context in which the capture of key government institutions took place, giving the politico-business elite control over reconstruction and monetary and fiscal policy, and resulting in the public debt crisis. In three important ways, the Hariri government broke from Lebanon’s traditional rentier and sectarian system. Firstly, their benefactors were not members of a religious sect or constituency, but of a new breed of politico-business elites drawn from the world of international finance and business. And secondly, the scale of the enterprise was much bigger, this was not a small scale-allocation of rents from a mid-level bureaucrat but involved a major overlap of public and private interests, which resulted in the channeling of huge amount of state funds towards private interests and the banking sector. Thirdly, this took place outside the realms of traditional state institutions in a quasi-private quasi-public administrative structure that in many cases bypassed traditional state institutions.

This type of capture goes beyond Marxist assertions that state policy will always serve the interests of elite groups. That definition of capture, the outcome of struggles over policy by elite groups and rival interests can be taken for granted in most states. Such struggles were present in Lebanon as well in debates over budget allocations or privatization of state sectors, such as the mobile phones example (Syria’s presence made these struggles even more complicated.) The Lebanese case, if we refer back to our theory, can be understood as a case of capture because the takeover of those institutions by the politico-business elite did not leave room for a negotiation or renegotiation of goals and priorities between the state and private actors/interests, since the elite and the private sector interests were one and the same. The elite’s lead role in the formulation and implementation of the reconstruction program, and control over monetary and fiscal policy, meant the state had no capacity to formulate a coherent or “encompassing” development vision, in the words of Bardhan, for the benefit of wider society.
It is interesting that Neoliberal pro-market policies were a good cover for the politico-business elite to promote oligopolistic practices by the banks, and to direct borrowed state funds towards the banking sector and their own interests through the reconstruction program. On the surface interest rates were "market determined" and contracts were awarded through "competitive" bidding, but in reality this was not the case. This highlights the importance of regulatory institutions in post-war societies in the realm of bank supervision, privatization and the handing out of private contracts, institutions that were essentially absent in Lebanon. This point is also highlighted by Addison et al., who note that in post-war societies "regulatory capture" of the financial sector common due to a weakening of state regulatory institutions after conflict. (Addison et al., p9)
6. Implications of Capture

The large diversion of state resources towards the banking sector in the post-war period, resulting from a capture of key state institutions by the Hariri government has had negative repercussions on Lebanese society in terms of losses in productivity, employment and an erosion of the middle classes. Despite the hopes offered by the reconstruction program, the fact is that in the first years of the new millennium, social inequalities and the gap between the rich and poor were more pronounced than in 1992. In the words of Georges Corm, what is needed urgently today is a “re-capture” of monetary and fiscal policy, and a new vision that attempts to re-link the financial and the productive (non-banking) sectors in the pursuit of more equitable economic growth. 31 The following section gives a brief overview of some of these developments.

6.1 Bank lending and “crowding out” of the private sector

Lending to the state overtook lending to the private sector in 1999, when 36 percent of total bank assets (i.e. equivalent to 90 percent of GDP) were going to the government to cover its deficits. These deficits, which have kept interest and lending rates high, have deprived the productive and non-banking private sectors of much needed credits. This, combined with the decline in government spending on reconstruction and development at the end of the 1990s as the largest share of state funds (some 43 % of total expenditure; see Charts 2 & 3) were now going to debt servicing, drove the country into recession.

The average dollar lending rate (90 percent of all lending to the private sector 31) was 11.3 percent (8.3 real rate) between 1995 and 2002, though it declined to around 9 percent (nominal) after that. Nominal rates on Lira lending have gradually declined from around 30 percent in the early 1990s to around 11 percent since 2003, though hardly anyone borrows in Lira. 33

In the chart 5, we can see a sustained decline in loans to the private sector as a percentage of total bank assets from 1999 onwards, going from 34 to 23 percent. This means that commercial bank

---

31 Interview with Georges Corm.
33 Central Bank figures.
assets grew at a faster pace than lending to the private sector (as we saw in table 8). The marked fall in lending to the public sector in 2003 to 2004 is explained by the receipt of $10.6 billion in concessional foreign loans following the Paris II conference in November 2002 to refinance the public debt. This meant the government had not much need for domestic borrowing those years.

**Chart 6: Commercial Bank loans to Government and Private Sector as a % of Total Assets**

![Chart 6](chart6.png)

Source: The Economist, various country reports; Iskandar 2004.

**Chart 7: Commercial Bank loans to the Government and Private Sector as % of GDP**

![Chart 7](chart7.png)

Source: The Economist, various country reports; Iskandar 2004.
In terms of GDP, what we see is that loans to the public sector have grown at a faster pace than loans to the private sector. The drop in loans to the public sector in 2003 is also explained by Paris II. Still, we see that loans to the private sector have grown steadily since 1994, but stagnated as of 1999 to remain between 80 and 90 percent of GDP, most likely due to the 1999-2000 economic recession. An important question is where are these private sector credits going?

What we find is that the distribution of loans by sector and region is skewed. Sixty-five percent of all loans (in 1999) were going to the construction and trade sectors, while in the productive sectors, industry accounted for only 10 percent and agriculture about 1-2 percent. In 2004, with the moderate decline in interest rates, the industrial sector's portion grew to 14, with the share of trade, construction and other services amounting to 57 percent. If one looks at the statements of industry leaders and merchants over the period, there is evidence of “crowding out.” A UNDP report of 1999 noted that manufacturing was operating at only 30 – 50 percent of capacity. “Industry leaders attempted without success to obtain a large reduction in fees for public services ... An improvement of the sector’s fortune requires the implementation of the bill facilitating access to short and medium term credit for small and medium enterprises.” (UNDP 1999, p11)

High interest rates were one of the key complaints of both the Association of Lebanese Industrialists and the Beirut Traders’ Association raised with the post-war governments in the 1990s. (Baroudi, p78)

Commenting on the situation, economist C. Nahas writes that “despite its pressing needs for investments and its large capital base, Lebanon is still waiting to see these [productive sector] investments. Instead, capital has been turned towards consumption; conditions for profitable investment have been eroded and internal and external imbalances have accentuated.” (Nahas, p69) Nahas blames the problem on the high debt and an incoherent allocation of “factors, risks and prices” which has resulted in “a destruction of the factors of production instead of a boost in the production of goods and services.” (ibid.)

---

6.2 Inequality

The crowding out of the private sector and the economic recession of 1999-2000 had repercussions in terms of unemployment and social inequalities. While post-war governments can be credited for the 250 percent increase in GDP from 1992 to 1998 and the glitz and glamour of downtown Beirut, an “encompassing” development vision, one that distributed the benefits more equally, appears to have been lacking. This is reflected in social and economic indicators, which show an increase of inequalities.

A study done by the central statistics office found that the lower income group in Lebanon has grown from 50 percent of the population in 1992, to 61 percent in 1999. The middle income group also declined from 40 to 29.3 percent of the population. These figures are compared to the “good old days” of 1974, before the war. (Maroun, p173)

Table 10: Distribution of income in Lebanon

<table>
<thead>
<tr>
<th></th>
<th>1974</th>
<th>1992</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>19.5</td>
<td>10.3</td>
<td>8.8</td>
</tr>
<tr>
<td>Middle</td>
<td>60.1</td>
<td>40.2</td>
<td>29.3</td>
</tr>
<tr>
<td>Low</td>
<td>20.4</td>
<td>49.5</td>
<td>61.9</td>
</tr>
</tbody>
</table>

Source: Central Statistics Bureau study, reproduced in Maroun 1999.

Another study confirms the increase in income inequalities between 1992 and 1999. In 1992, 80 percent of households received 60 percent of revenues, while in 1997 and 1999, 80 percent of households were receiving 50 percent of revenues. The remaining 20 percent of households were receiving 50 percent. Maroun says the social deterioration has to be redressed “but cannot be achieved by relying on the state (i.e. subsidies and credits) because of the current financial situation. Improving social welfare can be done through more appropriate means, like a revival of investment, a reorganization of the labor market and fiscal reform.” (Maroun, p180)

The monetary and fiscal policies resulting from state capture harmed the productive and non-banking private sectors in the post-war period. Even if some of these sectors, like industry and

---

34 GDP increased from $5.5 to $16.3 billion, while per capita income increased to $4500.
agriculture, have been traditionally less important in Lebanon, these findings confirm that there is no substitute for them when it comes to creating employment, redistributing resources more evenly, or creating the foundations of a healthy economy.
7. Conclusion: Moving Beyond the "Neoliberal-Monetarist Impasse"

This paper has reframed Lebanon's public debt crisis as a case of state capture. The capture of key state institutions by the politico-business elite of the Hariri government resulted from the unique post-war political and institutional context. This was defined as a weakness and erosion of traditional state institutions resulting from years of war, occupation by a foreign power, and political reforms that shifted power to the prime minister and cabinet. By capturing key institutions of the state, the elite consolidated its hold over reconstruction policy and monetary and fiscal policy, manipulating these to shift state of resources towards the banking and financial sector and other areas of personal interest. It was this capture that drove the Lebanese state to swiftly accumulate unsustainable levels of public debt. The policies pursued also largely disadvantaged the non-banking private and productive sectors.

These elements provided for a serious case of capture, which goes beyond the Marxist view that state policy will always serve the interests of elite groups, or be manipulated by elite groups, competing with each other to shape policy. These types of struggles over policy can be taken for granted in most states. Rather we describe the Lebanese case as a case of capture because the hold over the central bank, the finance ministry, the Council for Development and Reconstruction, and other state institutions, left no room for a "negotiation and renegotiation" of goals and priorities (as described by Evans and Bardhan) between different elite groups and the state. In fact, there was no other elite group that could effectively challenge these policies, and at the level of the institutions captured there was little distinction between the state and the politico-business elite. This is reflected in the overlap of public and private interests and in the close links between the politico-business elite and the banking sector. This case confirms the views of Addison et al. on the importance of having strong regulatory institutions in post-war societies to prevent a manipulation of economic policy.

While we must recognize the important contribution of post-war governments in reconstructing Lebanon, stabilizing monetary indicators, increasing GDP and restoring the country's traditionally large capital base, the question that must be asked is, was the price worth it? The weight of the debt and the failure, through these monetary and fiscal policies, to create linkages between Lebanon's huge capital base and the productive and private sectors is certainly one of
the tragedies of the post-war period. This is unfortunate given the consensus in the early 1990s among intellectuals and many policymakers that Lebanon should not recreate the skewed development policies of the past, neglect the productive sectors, and neglect the regions outside Beirut. This has had its implications, as we saw, in terms of unemployment and an increase of social and income inequalities in the first years of the new millennium.

As I have shown in this paper, there is no lack of intellectuals and thinkers in Lebanon that have articulated a new vision for progressive economic and social policies that can get the country out of the "Neoliberal-monetarist impasse" (to use the words of Ghassan Dibeh), the guiding ideology of the interests that took over key state institutions. However, with such a high debt burden, the costs of which will inevitably be borne by the Lebanese people, the adoption of a new vision is no longer a choice but a necessity. Either that, or Lebanon will have to deal with the consequences of a debt default, and will be forced to swallow the expected IMF medicine. In an era where developing countries are struggling to maintain a semblance of autonomy over their economic policies, this would be unfortunate.
Bibliography

Books:


Articles or Contributions:


Official Reports:


Interviews:


Other:
