Financial growth and economic development: a case study of Lebanon

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by

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A B S T R A C T

This thesis attempts to establish a number of relationships between financial growth and economic development and then to analyse financial and real development in Lebanon in the context of these relationships. It is the basic contention of the thesis that the financial structure of a country, consisting of a number of financial intermediaries generating financial instruments, can actively influence, if not determine, the course of real economic development in the economy. In Part I the analyses presented by Goldsmith, Gurley and Shaw, and McKinnon are examined to see how the relationships between financial growth and economic development have been interpreted by these writers. It is found that even a synthesis of their views does not fully comprehend the complexity of the inter-relationships and some further measures of financial structure are discussed in Chapter Three. A combination of the views in Part I suggest an approach which is adopted in Part II where financial growth and development are analysed in Lebanon from 1950 to 1974. Part II begins with a detailed analysis of the Lebanese economy with special emphasis being laid on the financial inadequacies of each economic sector. Secondly, in Part II a detailed description of the growth and operation of the financial sector is provided, along

with an analysis of monetary control. In Chapter Nine the various strands of the argument are brought together in an attempt to analyse the financial deficiencies of the Lebanese system, particularly with respect to projected growth targets contained in the latest national plan. The situation in the Lebanon is that the total resources of the financial sector are probably sufficient to meet all development requirements, but these requirements are largely long-term in nature, whilst funds deposited in the financial system are short-term in nature. In addition there is a complicating factor in that a large proportion of these funds are denominated in foreign currencies. Thus the total funds within the financial system over-state the extent to which the financial sector is capable of increasing domestic capital formation.

PREFACE

The original concept for this thesis came whilst I was preparing a dissertation for my Masters' degree at Indiana University. Whilst the dissertation was ostensibly about central bank control in Nigeria, the long discussions I had with Professor E. Wicker ranged over the whole problem of financial growth and economic development. I took this interest with me to Durham in 1966 and generous financial support from the Middle East Centre in Durham University allowed me to visit a number of Middle Eastern countries, particularly Lebanon, to gather material on financial institutions, between 1966 and 1970, from which I was able to publish a number of articles. In 1970 I felt I had enough basic data to form the backbone of a doctoral thesis and the present thesis is the result of fieldwork conducted in Lebanon since 1970.

The people who have helped me throughout my work are too numerous to mention, but I would like to acknowledge the considerable help given by Salim Hoss, first of the Control Commission and now director of the National Bank for Industrial and Touristic Development; Mr. A.A. Badrud-Din of the Central Bank; Pierre Masaad of the Central Statistical Bureau, who first introduced me to the hazards of interpreting Lebanese statistics; virtually every

major banker in Beirut who at some time or other was plagued by my questions, but especially Alastair Fairlie of Barclays Bank, who provided me with a very comfortable room to do my work in and introduced me to numerous people without whom this work would not have been completed. I would like to extend further thanks to many of the staff of the American University of Beirut, who at times thought me mad to try and analyse how the banking system worked, but, nevertheless, argued constructively with me.

In Durham, I would like to thank numerous colleagues (past and present) who have read parts of this thesis and were good enough to comment extensively, and at times scathingly, on my work. These include Walter Elkan, Bertie Hines, Denis O'Brien, Rodney Wilson, Julian Bharier and John Hey. To Lovaine Ord I owe a special debt as she has, unflinchingly, typed, re-typed and typed again more drafts than I care to mention. In the final stages I would like to acknowledge the debt I owe to Elias Ghantus, now a research student in Durham, but someone with an extensive knowledge of the Lebanese economy on whom I could always rely for helpful comments. In addition I am grateful to him for helping me with the collection of data, the translation of some arabic material and the arrangement of a seminar in Beirut where I was able to put my views before a group of experts from the United Nations Office

in Beirut. The continuing support of the Centre for Middle Eastern and Islamic Studies both in terms of financial support and documentation is gratefully acknowledged. In particular I would like to thank Richard Lawless and his staff in the Documentation Centre for all their help.

Finally I owe a great debt to my wife, Rosalind, who encouraged me to start this work and encouraged me to finish it. When things did not seem to be coming out I could always rely on her to push me a bit further towards the finishing post.

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C O N T E N T S

PART I

PART II

P A R T I

C H A P T E R O N E

Financial Growth and Economic Development

Introduction

> . . . It has become clear since the 1950's that money, and not only money but also other financial instruments, "matter" in the sense that the course of real economic development may be considerably influenced, even if it is not basically determined by a country's financial structure and activities . . . [1]

Goldsmith's view of the role of the financial sector in the economic development process can be taken as a general statement about the intent of this thesis and also can be taken as an introduction to the substance of this chapter. Gurley and Shaw in particular are recognized as being instrumental in establishing the view put forward by Goldsmith. In this chapter the basic characteristics of the Gurley and Shaw model are introduced and extended beyond a description of financial instruments and policies to a more detailed discussion of different financial intermediaries within the financial sector.

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1. R.W. Goldsmith, "The Development of Financial Institutions During the Post-War Period", Banco Nazionale del Lavoro Quarterly Review, No. 97, June 1971, p.129.

2. J.G. Gurley and E.S. Shaw, Money in a Theory of Finance, (Washington: Brookings Institution 1960).

To understand more fully the role of the financial sector in the process of economic development requires a prior analysis of the role of money itself in a developing economy. Traditionally monetary and real phenomena have been analysed separately. Thus in a Classical system money is introduced only as a medium of exchange and is not hypothesised to have any influence on relative prices.[3] The introduction of money into macroeconomic models has been done in two particular ways. Metzler, in particular, has shown that where savings are dependent on real wealth (here real wealth is composed of holdings of physical capital and monetary assets), an exchange of one form of wealth for another can affect the community's total savings and hence, ultimately relative prices through changing interest rates, which affect the growth rate of output.[4] Secondly, Gurley and Shaw have demonstrated that if money is defined as consisting of two elements: inside money (money based on private domestic primary securities) and outside money (money that is backed by foreign or government securities or gold; or fiat money issued by the government), and if the ratio of inside money to outside

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3. P.S Laumas and K.A. Mohabbat, "Money and Economic Development", Indian Economic Journal, Vol.XX, No's 4 and 5, April-June 1973, p.619.

4. L.A. Metzler, "Wealth, Savings and the Rate of Interest" Journal of Political Economy, Vol. 59, April 1951, pp.93-116.

money can be changed by the government through an expansion of outside money, which does not induce an equi-proportionate change in inside money, then again wealth holdings will alter affecting interest rates and thus influencing relative prices.[5]

Bearing in mind these rather fundamental relationships between money, wealth and growth, it is surprising that growth models have proceeded for so long as though money did not exist. Hahn and Matthews in the introduction to their monumental survey of growth economics in 1960 isolated many factors which they thought were important in analysing growth processes; but failed to mention money.

> ". . . A fully articulated model of growth requires to be made up of a number of building blocks. It requires to specify functions relating to the supply of labour, saving, investment, production, technical progress and the distribution of income, to name only the most important . . ."[6]

The problem has been that many models of economic growth have adopted the standard characteristic of comparative static models - that is that there is a long-run invariance between the demand for real money balances and the nominal quantity of money, i.e. money is neutral. By making this assumption growth theorists can then proceed on the

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5. A.H. Meltzer "Money, Intermediation and Growth", Journal of Economic Literature, Vol. VII, No. 1, March 1969, p.30.

6. F.H. Hahn and R.C.O. Matthews, "The Theory of Economic Growth: a Survey", in Surveys of Economic Theory: Vol. II, (American Economic Association and the Royal Economic Society: Macmillan) 1965, p.2.

assumption that monetary phenomena have no influence on real variables. It is certainly true that since Hahn and Matthews surveyed growth models, a considerable literature has developed on the relationships between money and growth.[7] However, the analysis of the process of economic development has, until recently, adopted the non-monetary view of growth, such that considerable stress has been laid on the utilization of real resources. Such a stress is not surprising. A wide range of development textbooks begin by discussing measurements of developments. Despite numerous caveats and enumeration of drawbacks, national income data tends to be put forward as a measure of economic development. National income data measures the money value of final output. By its very nature it fails to measure the value (here defined in strictly economic output terms) of financial activity.

A financial system which allows final transactions to occur will only show up national income accounts in terms of the total employment and hence total expenditure generated in that sector. Thus the more intangible benefits of financial activity are not measured. As Porter has commented,

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7. In particular surveys by A.H. Meltzer, op. cit., and J.L. Stein, "Monetary Growth Theory in Perspective", American Economic Review, Vol. LX, No. 1, March 1970, pp.85-106, point to size of the literature in this field.

> ". . .(The) concern of underdeveloped countries for the size of their banking system is difficult to comprehend. Banks make almost no direct addition to national output; and the product of banks, the actual and imputed deposit and checking services, are surely of low priority as consumer goods in nations impoverished of food and clothing. Of course, the concern of the developing economies for the growth of their banking system is not premised on any such narrow conception of the contribution of banks. What is recognized as relevent is the indirect contribution to the growth of real variables which a growth in monetary variables can make. Exactly what the connection is between these two sets of variables is not always so clearly recognized . . ."[8]

It is hoped that the arguments presented in the next three chapters will go some way to making these connections more recognizable. However, if national income data becomes the basic way of measuring economic development, then it is not surprising that so much emphasis has been placed on increasing factor inputs as a means of accelerating economic development. As Laumas and Mohabbat have commented,

> ". . . The process of economic development, it is widely believed, is essentially a real phenomenon. The increase in real resources and their effective utilization determines the rate of economic progress. This view does not seem to adequately stress the importance of money in economic development. Experience does not warrent such an emphasis on the relative roles of real and monetary factors . . ."[9]

This same theme was developed more forcibly earlier by Gurley and Shaw when they stated,

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8. R.C. Porter, "The Promotion of the 'Banking Habit' and Economic Development", Journal of Development Studies, Vol. 2, No. 4, July 1966, p.346.

9. P.S. Laumas and K.A. Mohabbat, op. cit., p.619.

> ". . . Economic development is commonly discussed in terms of wealth, the labour force output and income. These real or "goods" aspects of development have been the centre of attention in economic literature to the comparative neglect of financial aspects. Yet development is associated with debt issue at some points in the economic system and corresponding accretions of financial assets elsewhere. It is accompanied too by the 'institutionalization of saving and investment' that diversifies channels for the flow of loanable funds and multiplies varieties of financial claims and in other terms of trading in loanable funds. Development involves finance as well as goods."[10]

The analysis so far seems to suggest three lines of approach. Firstly, a discussion of the role of the money commodity in the development process is necessary. Secondly, a discussion of the ways in which the generation of financial instruments affects the savings investment process and ultimately the real rate of growth of output, and, thirdly, a discussion of the ways in which specific financial structures may influence economic development. These three aspects are now considered in more details and a number of ramifications of the basic analysis are presented in chapter Two and chapter Three.

For the purposes of this study a financial system is defined as containing all those institutions which deal, in one way or another, with financial instruments, i.e.

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10. J.G. Gurley and E.S. Shaw, "Financial Aspects of Economic Development", American Economic Review, Vol. ZLV, No. 4, September 1955, p.515.

claims held by individuals or groups in the economy against other individuals or groups. Such claims may be against, for example, governments (fiat money), private companies, (shares) or individuals (loans). Thus a financial system contains a wide range of financial intermediaries all involved in the basic function of interposing themselves between ultimate savers and ultimate investors.

Money and Development

Shaw in introducing the concept of financial deepening as an element in accelerating the growth of real output comments that,

> ". . . Some development theory seems to be designed for a barter world . . .[11]

He goes on to argue that the role of finance is often, at best, seen in a passive light and at worst is ignored altogether. Our discussion of the relationships between money and development begins by looking briefly at the characteristics of a barter economy and goes on to explore the benefits and problems that money bestows on exchange relationships as an economy moves out of a barter situation.

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11. E.S. Shaw, Financial Deepening in Economic Development, (London: Oxford University Press 1973) p.4.

In a barter economy trade takes place between commodities in real terms. In other words commodities are valued in terms of each other. It was a simple barter system like this that Patinkin analysed to discover the effects that the introduction of money would have on such a system.[12]

In a pure tatonnement barter system, exchange takes place when all excess demands for goods and all excess supplies of goods can be simultaneously satisfied. An exchange economy of this sort can use any of the goods bartered as a medium of exchange. Alternatively, no one commodity needs to be chosen as a medium of exchange. It is always possible to conceive of one-to-one trading of one commodity against another. However, this requires that separate trading conventions must exist for each trade. If direct trading of one commodity for another is allowed, then, for n commodities, $\frac{1}{2}n\,(n-1)$ trading arrangements will be necessary.[13] If a single commodity is used as a medium of exchange the number of trading arrangements is reduced to n - 1. If we take an example where n = 100 then the trading arrangements in the direct trade situation amount

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12. D. Patinkin, Money, Interest and Prices, 2nd ed. (Harper and Row, 1965).

13. This is the approach adopted by R. Clower in his introduction to Monetary Theory (Penguin Modern Economic Readings 1969) p.11. The formula is derived from the sum of the first n - 1 integers for n commodities; that is assuming the nth commodity does not trade with itself.

to 4,950, whereas if one commodity is used as a medium of exchange the number of trading arrangements is reduced to 99. Therefore the use of one commodity as a means of exchange in barter exchange can be rationalized purely in terms of the reduction of trading costs per trade

Patinkin has argued that by introducing fiat money as the nth good in the set of tradeable goods the barter economy can be defined as a monetary economy. Patinkin proceeds in the following manner. Each individual is assumed to be maximising a utility function of the following form:

$$U_j = U_j\ (d_{1j},\ d_{2j} \ldots\ldots d_{nj},\ {}^{Mj}/P), \qquad (1)$$

Subject to the budget constraint

$$\sum_{i=1}^{n} P_i\ (d_{ij} - s_{ij}) + Kj - M^1 j = 0, \qquad (2)$$

Where s_{ij} and d_{jj} represent initial and desired quantities of goods, with $M^1 j$ and Mj representing initial and desired quantities of commodity money. At an equilibrium vector of prices, P, all excess demands and supplies are identically equal to zero. In this world individual consumers do not contract to hold surpluses or deficits for the future.[14] Clower has argued that the choices presented in the budget constraint (2) do not constitute the correct choice mechanisms for a monetary economy. If all excess

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14. The analysis presented here follows that presented by R. Clower "A Reconsideration of the Micro-foundations of Monetary Theory" Western Economic Journal Vol. 6, No. 1, Dec. 1967, pp.439-369.

demands and supplies are identically equal at an equilibrium vector of prices then notional and effective excess demands must also be equal.[15] This implies that any good offered for sale is at the same time a source of effective purchasing power over another good. However, money interposes between goods in the exchange process in a monetary economy such that a notional demand for a commodity can only become effective through the ability to pay in terms of money. Thus the acquisition of money becomes a precondition for commodity exchange. This prior acquisition is not an explicit part of the budget constraint provided by Patinkin. For, indeed, if the nth commodity, money, is desired by only one individual then the medium of exchange flows to one individual; but trade is still possible in the n - 1 commodities. Presumably some other commodity can now be chosen as the money commodity and trade will take place. Assuming that the money commodity is again only demanded by one individual then in the limit the economy is reduced to two commodities, which is characteristic of a barter economy not a monetary economy. This is, of course, an argument by way of a reductio ad absurdum. It assumes that each transactor consumes some of all the goods in order to rule out corner solutions. It is arguable that empirically this solution would be unlikely. However, as the questioning in this type of

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15. A.G. Hines, On the Reappraisal of Keynesian Economics, (Martin Robertson 1971) p.16.

model is largely a priori, the procedure adopted is a valid way of dealing with the matter.

The analysis presented by Clower implies two things which are relevant to the more specific analysis of this thesis. Firstly, the introduction of money into an economy has the effect of reducing both transaction and waiting costs of exchange and, therefore there is a general gain to society through the process of monetization and secondly, as money interposes itself between the demand for goods and the supply of goods, notional and effective excess demands may not necessarily be equal which in its turn may lead to the under-utilization of real resources. Here it is being suggested that the real growth rate of output may be influenced by the ways in which demands are made known in the economy. This point is merely established here; but is covered in more detail when discussing the impact of money on the savings/investment process.

We can revert back to the simple characteristics of the exchange economy to see how deficits and surpluses may arise within the trading period. Individuals hold money as cash balances in order to consume commodities at a particular point in the future. The tatonnement process ensures that all trading contracts are equilibrium ones and it also determines a unique distribution between real balances and commodities for each individual for that week. Although the contracting process at the beginning

of the week determines the total level of consumption within the week, it does not determine at what points during the week all contracts are actually settled. The fact that physical buying and selling at an equilibrium set of relative prices may be distributed randomly over the trading period (in this case one week) provides the rationale for the holding of real cash balances. It also implies that temporary deficits and surpluses may occur during the trading period. In this case the deficits and surpluses are unplanned in that they occur as a result of the ways in which trade takes place during the week and do not occur as part of the plans of the transactor at the beginning of the week. If it is assumed that one of the prime purposes of financial intermediaries is to accumulate deposits from surplus groups and to distribute loans to deficit groups, then it is possible to conceive of a financial system developing in this simple exchange economy.

The strength (or weakness) of this argument rests very much on how a deficit or surplus is defined. Deficits and surpluses which occur within the trading week can be described as being temporary in nature in that they are basically unplanned. Although they may be unplanned they constitute a considerable problem for the individual trader. One of the principle problems of exchange in a barter economy is that there needs to be simultaneous satisfaction of wants. It is no use going to market with bananas to exchange for apples, if the person holding

apples wants pears. In this case at least three traders are required to effect the exchange. The introduction of a money commodity is supposed to eradicate these problems of multilateral trade; but in fact a different problem arises in the use of a money commodity. Unless all buying and selling patterns can be perfectly synchronized in the trading week an individual, at any one moment in the week, may have an excess demand for cash balances. This is because in this model the execution of contracts is a random variable and individuals presumably attach disutility to the inability to pay on demand.[16] The excess demand for cash balances will be equal to the excess supply of goods which have been sold under contract; but not yet collected. Therefore equilibrium at the end of the trading period does not necessarily imply equilibrium throughout the period. If deficits and surpluses of this nature occur within the trading period then it is possible for a financial system to develop. In other words, individual traders with an excess supply of real balances and traders with an excess demand for real balances may be simultaneously satisfied by a simple borrowing/lending system.

Within the confines of the weekly trading period the lending/borrowing process will presumably be restricted to

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16. Here consumers derive satisfaction (utility) from not only spending money; but also holding it.

call loans. However, this process in itself establishes a rationale for a financial intermediation process to develop. It doesn't at the moment, imply anything about the financial structure.

Such a system, to accommodate random payments within the period of the week, is not explicitly covered by Patinkin. Patinkin defines an equilibrium level of real cash balances as one which is "adequate" to cover total expenditures within the trading week. But this adequacy is defined in terms of total expenditure and not in terms of the incidence of payments and receipts within the trading week. In fact Patinkin reserves the explicit introduction of deficits and surpluses to a situation where the individual's economic horizon is extended from a week to a month. In this case expenditure plans are made for a four week period, assuming that income is replenished at the beginning of each week. It is possible for the individual to plan over the whole period and, what is more important, adjust his consumption patterns, as information is made available at the beginning of each week. Though the individual's income is fixed in terms of his initial endowments, he can change his consumption patterns on a week to week basis by either running down his money balances or purchasing a new commodity in the system - a bond. The process of dissaving by an individual means that expanditure is in excess of income, and therefore the

individual will borrow. This borrowing is done by issuing a bond. The bond represents a promise to pay a fixed sum of money at some future date, plus an interest charge. If we assume that there is no risk of default, then the interest rate represents the reward to the buyer of the bond of foregone consumption. It is important to notice in this analysis that the emergence of a bond market is dependent upon the simultaneous emergence of creditors and debtors in the market. For this to occur we have to assume that expectations about the future are not held equally by all consumers or else we have to specify that consumers have different tastes for future and present consumption. If all consumers were to behave in the same way then the two sides of the bond market would not emerge.[17]

So far our analysis has allowed us to consider two situations. One where unplanned deficits and surpluses may occur within the trading week, and one where planned deficits and surpluses may occur when the economic horizon is extended over a number of weeks. As far as Patinkin's analysis is concerned these two situations are clearly identifiable separately; but as far as the analysis of financial intermediation is concerned they are equivalent situations. A financial system is primarily concerned with providing financial instruments which are capable of

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17. More specifically the internal rate of discount for each consumer may be different. Time differences can be rationalised purely in terms of the "life style", as proposed by M. Friedman, "The Optimum Quantity of Money", in The Optimum Quantity of Money and Other Essays, (London: Macmillan 1969) p.26.

simultaneously satisfying debtors and creditors and this provision can be made irrespective of whether the deficits and surpluses are unplanned or planned. The only distinction to be made relates to the amount of information which may be available to financial intermediaries. If unplanned deficits and surpluses occur, it is possible that insufficient information may be generated in the market making financial intermediation difficult. When deficits and surpluses are planned then we can assume that consumers make their intentions known, thus allowing a financial system to emerge. Clearly the function of financial intermediaries in this case is to act as a "bridge" between deficit and surplus units. This defines the function of financial intermediaries; but not necessarily the rationale. It is clear that all individuals who receive income could act as their own intermediaries and all consumers could seek funds individually. The rationale is really defined in terms of the opportunity costs of buying and selling securities by the individual. In other words, financial intermediaries establish a comparative advantage over other units in the economy in the provision of financial instruments. This conclusion is an important one for the theory of financial intermediation, as it implies that financial intermediaries, over time, are able to develop a body of information which makes them superior to individuals in financial exchanges. The point implicit in this analysis is that in a monetary economy

there is a cost involved in acquiring information about market conditions and relative prices. This cost can be minimized if a commodity is available with particular technical characteristics, such as non-perishability, and low marginal costs of acquiring information, i.e. with a unit of account information for a number of commodities is standardized. This particular characteristics of money is very important in monetary economics and led Brunner and Meltzer to conclude;

> ". . . Money is a substitute for the specialised market skills that are part of a transactor stock of knowledge or 'human wealth'. Resources allocated to search and the maintaining of market information can be reallocated once money is used as medium of exchange. Trade and the market system expand, and the economy becomes increasingly monetized. More and better quality information becomes available with the expansion of the market and the opportunities for division of labour that lead to the development of professional transactors such as brokers and specialists . . .[18]

Thus monetization itself can generate benefits in that it reallocates resources to more productive uses and, by establishing a common unit of account, facilitates trade. We now need to see how further benefits may be derived from monetization through the development of a financial intermediary system.

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18. K. Brunner and A.H. Meltzer, "The Uses of Money: Money in the Theory of Exchange Economy", American Economic Review, Vol. LXI, No. 5, December 1971, p.804.

Financial Intermediation

The payment for goods involves the individual transactor in holding cash balances. Presumably individuals will wish to minimize their cash holdings at any one time subject to the constraint that all desired transactions can take place. Given this type of situation a simple borrowing/lending system may develop as has been indicated already. This simple point can now be extended, along the lines indicated by Gurley and Shaw.[19]

Firstly we need to define the various types of spending units which may exist in the economy. Those units with balanced budgets will not generate a demand for or supply of financial instruments, since their total expenditure equals their total receipts over time. However deficit budget units and surplus budget units will generate a demand for finance, since in the first case expenditure is in excess of receipts creating a demand for finance and in the second case receipts are in excess of expenditure creating a supply of finance. This simple breakdown into types of spending units does not provide an immediate need for financial intermediaries. Indeed deficit units may finance their excess expenditure today from excess receipts yesterday and vice versa for surplus units. In

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19. J.G. Gurley and E.S. Shaw, "Financial Aspects of Economic Development", op. cit.

this case financial activity is external to the spending unit in that financial resources necessary to maintain an excess of expenditure over receipts are demanded from outside of the spending unit. However this demand for finance may be satisfied through direct lending from the surplus units (direct external finance) or indirectly (indirect external finance) through financial intermediaries. Direct external finance relies on information about surplus budget units being immediately available to deficit budget units. In addition there will be search and transfer costs associated with direct external finance. We have already seen that the existence of financial intermediaries can be rationalised by the comparative advantage they establish over other economic units in the provision of financial services. Thus as an economy becomes more sophisticated it would be expected that indirect external finance would tend to predominate over direct external finance. This is the result found by Gurley and Shaw for the United Stated since 1900. They found from 1900-1930 the proportion of indirect external finance to total external finance increased, although there were cyclical fluctuations during the period. Thus the Gurley and Shaw analysis rationalises the prime activities of financial intermediaries as being the gathering of loanable funds from surplus units in exchange for their own indirect debt. This analysis, by definition, has nothing to say

about balanced budget units. This, in fact, seems to be a weakness in the analysis. From what has been said already in this chapter the significance of balanced budget units depends very much on how one defines the time period over which the budget is balanced. If the relevant time period is one month or one year, then a balanced budget at the end of this time period does not necessarily imply a balanced budget throughout the period. Indeed analysis of the transactions demand for money would suggest that, in the case of a spending unit receiving a fixed income at the beginning of each month and disbursing it all during the month, the role of financial intermediaries must not be ignored. As Baumol has pointed out, if an individual transactor is able to assess the opportunity costs of holding cash, as against holding interest-earning assets, and the potential "brokerage" fees (i.e. the costs of shifting from interest-earning assets to cash), then it is possible for the transactor to minimize his cash holdings at any one point during the transactions period.[20] Baumol's analysis suggests that the average transactions cash balance for the individual should be one half of the size of the optimum holding per time period. This analysis suggests that spending units that have inter-temporal

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20. W.J. Baumol, "The Transactions Demand for Cash: An Inventory Theoretic Approach", Quarterly Journal of Economics, Vol. 66, November 1952, pp.545-556.

balanced budgets may have excess cash holdings during any one period. These excess cash holdings have no utility attached to them, in that they are in excess of any demands put upon them. In this case there may be created a temporary supply of funds which will act as an increase in loanable funds in the financial system as a whole. Thus balanced budget units may influence the financial system. This is a point not considered by Gurley and Shaw.

An interesting point that can be developed out of this analysis is that as the procedures for wage or salaries payments become more institutionalised there will be a tendency for financial intermediaries to become a repository for short term funds. This expansion in total deposits, although short-run initially, can become a permanent increase in deposits if wage and salary earners by and large accept the new convention. This means that spending units that might be classed as balanced budget units in fact may actively influence the size of the financial sector.

So far we have seen that the process of exchange in a monetary economy implies that individuals at some time should have recourse to a simple borrowing/lending mechanism. In addition it has been demonstrated that the lending/borrowing mechanism will be provided by financial

intermediaries if they can establish a comparative advantage over individuals. Once this comparative advantage has been established Gurley and Shaw argue that total debt in relation to income and wealth will rise faster than under a regime of direct or internal finance. They go on to conclude that,

> ". . . Institutionalization of saving and investment quickens the growth rate of debt relative to the growth rate of income and wealth . . ."[21]

The conclusion from this statement must be that a lack of indirect external finance will effect the growth rate of output, since a system relying solely on direct internal or external finance is faced with a number of constraints, such as the generation of insufficient funds for investment projects (in the internal finance situation) and the accumulation of undifferentiated direct debt by surplus budget units (in the direct external finance situation) if deficit budget units continually acquire increasing quantities of loanable funds. Of course the steady accumulation of undifferentiated debt may only occur at an increasing cost to borrowers which may inhibit investment, thus a negative feed-back effect on output is created.[22] Thus, bearing in mind the attitudes of surplus

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21. J.G. Gurley and E.S. Shaw, op. cit., p.519.

22. R.J. Morrison, "Financial Intermediaries and Economic Development", Scandanavian Economic History Review, 1967, pp.56-70.

budget units and assuming that investment is responsive to some degree to changes in interest rates, the role of financial intermediaries becomes clear. It is,

> ". . . that they enable surplus units to diversify their portfolios by offering their own (the financial intermediaries) indirect debt in place of the direct debt which they (the surplus units) had formerly been accumulating. Thus by taking the direct debt of deficit budget units, financial intermediaries, undertaking indirect external finance, exert a downward pressure on interest rates and enhance the borrowing and lending of loanable funds".[23]

This downward pressure on interest rates derives from the cost savings which accrue to a financial intermediary as total debt increases. The margins between the rates of interest on deposits with the intermediary and its own loans will represent two things (a) the direct cost of accumulating funds and contracting loans; here there is a notion of search costs and a risk cost of default by the borrower, and (b) a notional profit margin for the intermediary. If we assume perfect capital markets, as Gurley and Shaw do, then (b) simply becomes long-run normal profits. From this base we can argue that as the total flow of funds to the intermediary increases the average cost per unit of currency deposited will decline, i.e. fixed costs become less significant and there are economies of scale in variable costs. This implies that the margin between lending and borrowing rates can narrow

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23. R.J. Morrison, op. cit., pp.57-58.

and, therefore, the process of intermediation proceeds at a faster rate than a system of direct or internal finance simply because there are cost savings available to the intermediary which are not available in the direct or internal finance situation as Gurley and Shaw describe them.

We can now relate this discussion about financial intermediation to the growth of real output. The natural linkage between the financial sector and the real sector is through the saving/investment process. This process has two aspects. Firstly, savings represents non-consumption today and investment represents increased consumption tomorrow. So changes in savings and investment represent a re-structuring of the community's demand for real resources over time. Not only do changes in savings and investment affect the real sector, the changing demands will have financial implications in a monetary economy. An individual who decides to save a certain proportion of his current income will do so mainly in the form of acquiring financial assets or building up his cash balances. In the former this act of saving will affect the financial system. An individual or corporate body that decides to invest will create a demand for loanable funds, again affecting the financial system. This is a crucial though often overlooked point when considering the demand for investment. In practice the demand for

capital goods represents a willingness on the part of the demander to exchange capital goods for money. Therefore, if the demand for capital goods is to be made effective it involves a prior acquisition of funds. Unless this acquisition is internal or direct, then the financial system is influenced. Thus when loanable funds are acquired through indirect external sources, then an increased demand for physical capital has a direct counterpart in the market for loanable funds and hence influences the financial system. This describes what can be termed the minimum effect. A more substantial effect is possible if direct external or internal finance units use the financial system. The importance of this latter effect lies in the fact that if business firms merely use the financial system in a short-term sense and they do not contract any significant debt with the financial system, then there will be a tendency for the financial system to accumulate short-term liabilities, which will require a high level of liquid assets as backing thus inhibiting financial growth in long-term markets. This means that a financial system in terms of its total assets or liabilities may seem to be important in terms of the ratio of its assets to G.N.P., but is in fact insignificant in terms of providing financial instruments to deficit units. This is an important point which will be developed fully in Part II of this thesis when discussing the case of Lebanon.

Broadly speaking the interjection of financial intermediaries in the saving/investment process will result in the financial intermediaries purchasing primary securities from investors and issuing financial assets to savers. The growth of the issue of primary securities can thus be taken as one measure of the extent to which an economy has been influenced by financial intermediation. Gurley and Shaw suggest that primary security issues as a percentage of G.N.P. typically fall within the range of 1-2% for poor (less developed) countries and 10-15% for rich (developed) countries.[24]

Looking at financial intermediation secularly then broad trends suggest that as income and wealth grow so does the rate of financial asset accumulation.[25] What has not been established so far is whether financial asset accumulation is both a necessary and sufficient condition for real output growth. The implication of much of Gurley and Shaw's analysis is that the development of a financial system involving an increasing volume of indirect external finance will accelerate the growth rate of output above the rate which would have prevailed had a situation of

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24. J.G. Gurley and E.S. Shaw, "Financial Structure and Economic Development", Economic Development and Cultural Change, Vol. 15, No. 3, April 1967, p.259.

25. These sorts of trends are suggested by R.W. Goldsmith in Financial Structure and Development (New Haven and London: Yale University Press 1909) and are discussed more fully in chapter 2.

only direct internal and external finance prevailed.

However, as Morrison suggests,

> ". . . This model (Gurley and Shaw's) has two basic but crucial premises. It assumes a certain level of development and it assumes the existence of perfect capital markets. The importance of these assumptions, and especially the latter, is that they are necessary to assure significant adjustment to marginal changes in the rate of interest . . . Therefore the general applicability of the model to economies in an early stage of development becomes somewhat dubious . . ."[26]

The existence of perfect capital markets assures the appropriate adjustments will take place to differing volumes of indirect securities. As Morrison points out, this type of adjustment mechanism may not be feasible in rudimentary capital markets characterized by imperfect information. One way to adjust the Gurley and Shaw model to take account of Morrison's criticisms is to hypothesise a dual economy situation, as suggested by Bennett, with a traditional sector which is basically self-financed with a preponderence of internal finance and a modern 'progressive' sector where a shift to indirect external finance encourages the growth of financial services.[27] This economic dualism approach to financial intermediation is appealing as it allows the combination of the basic postulates of the

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26. R.J. Morrison, op. cit., p.58.

27. R.L. Bennett, The Financial Sector and Economic Development (Baltimore: The John Hopkins Press, 1965) especially pp.22-25.

Gurley and Shaw model along with a realistic appraisal of the economic facts of low income countries; and it is this approach which is developed in chapters Two and Three and applied in Part II of the thesis.

The arguments so far provide a rationale for the development of a financial system and for the development of financial instruments. Nothing has been said so far about financial structure. In fact we may find it very difficult or even impossible to specify a given set of financial instruments and a corresponding financial structure. Let us consider this problem in a bit more detail.

The Financial Structure

Arguing on a priori grounds it is clear that for any given level of real output we can conceive of an optimal financial system (that is optimal in terms of size and functions). It is not clear however, that the optimum functions (in terms of credits granted) will necessarily correspond with a unique financial structure. In other words a specific set of financial functions may be carried out by a number of different financial institutions. Therefore, even if it is possible to specify correctly the optimal functions of a financial system in relation to

any given level of real output, it is not necessarily possible to specify, uniquely the types of institutions which will perform these functions. In practice the problem may be even more complicated. It is quite clear that financial intermediaries in general can provide a range of financial services based upon a specific holding of assets. If the rates of return on particular assets are such as to make certain assets perfect substitutes for each other, then the provision of financial services may be achieved through differing portfolios. Although the services offered by the financial intermediaries through these portfolios may be identical the actual combination of assets held may be different and may affect other markets in various ways. This shows that although an optimum may be defined for the financial system, in respect of a given level of real output, in terms of its structure and, separately, in terms of its functions, it may not necessarily be possible to define them simultaneously.

If the foregoing arguments are accepted then our analysis of any financial system can be, at best, only partial. We can view the problem as one where a given total volume of financial instruments is consistent with a given real growth rate, but is also consistent with different financial structures (because some financial instruments may be perfect substitutes for each other as far as the borrower is concerned; but not as far as the lender is

concerned). Thus identical assets may be held exclusively by different intermediaries. As Hines has pointed out,

> ". . . We might . . . find that there is no one to one correspondence between the inter-connected set of real variables and the corresponding financial structure. . ."[28]

Alternatively, we can view the problem from a given financial structure and see what financial instruments are generated and how these instruments are related to real growth. This second approach is perhaps more pragmatic, and it is certainly more useful from an empirical point of view, since we can take the financial structure we observe as given in terms of providing financial instruments to deficit units. This is an important point which will develop at a later stage with specific reference to the Lebanon.

The arguments presented so far can be summarized as follows. In a monetary economy the process of real growth necessarily implies the growth of a financial system. This assertion is based on the fact that all transactions in organized markets in a monetary economy are facilitated through a medium of exchange. This medium of exchange needs the essential property of universal acceptability. Beyond this the actual nature of the money commodity is less important. As Clower states,

> ". . . The technical characteristics of commodities chosen to serve as 'money' are of minor economic

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28. A.G. Hines, On The Re-appraisal of Keynesian Economics, (London: Martin Robertson and Co. Ltd., 1971) p.55.

> importance; what matters is the existence of social institutions condoned by either custom or law that enable individuals to trade efficiently if they follow certain rules - in particular the rule that one commodity traded in every exchange should be socially sanctioned as an exchange intermediary."[29]

Therefore the accumulation of cash balances is a necessary prerequisite for real exchange. However, the processes of exchange are not necessarily perfectly synchronized and, therefore, at any one moment in time deficit and surplus groups may exist in the economy.

These deficit and surplus groups may be able to accommodate each other, in a financial sense, to allow for a situation where realised expenditure is in excess of realised income for deficit groups and realised income is in excess of realised expenditure for surplus groups. From this we can develop a further argument that this process of financial exchange will be facilitated through the development of a financial intermediary system, since such a system will, in the long run, be able to establish a comparative advantage over individual trading units in the provision of financial services. Through the role of financial intermediaries as issuers of indirect debt, the financial sector becomes an integral part of the saving/ investment process and hence becomes related to the real growth rate of output. However, how real output is

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29. R. Clower, Readings in Monetary Theory, Penguin Modern Economics Readings (London: Penguin Books 1969) p.13.

influenced will be dependent on the range of financial instruments generated by the financial sector and the specific institutional structure of the sector. It is to these two matters that chapter Two addresses itself.

C H A P T E R T W O

The Determinants of Financial Structure and Development

Chapter One demonstrated that the process of economic development has both a real aspect and a financial (monetary) aspect. It was also suggested that the institutionalisation of financial processes will accelerate the growth rate of debt relative to the growth rate of income and wealth. The relatively faster growth rate of debt is dependent upon the emergence of financial institutions capable of acting in an intermediary capacity between savers and investors. This chapter examines a number of separate determinants of financial structure and the ways in which financial structures may influence development.

Financial structure is basically determined by a combination of financial instruments and financial institutions.[1] According to Goldsmith the most important relationships to consider are the ratio of financial assets to total tangible assets; the distribution of financial assets and

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1. R.W. Goldsmith, Financial Structure and Development, Studies in Comparative Economics No. 9, (New Haven: Yale University Press 1969) p.26.

liabilities as between different financial instruments and the distribution of these financial instruments between financial intermediaries. These stock relationships and their flow counterparts separately and collectively will give measures of the financial structure of the economy. Equally, over time, measures of the ratio between issues of financial assets by financial intermediaries and issues of assets by non-financial units will give an indication of the institutionalisation of the financial process.[2] We need to examine these basic relationships in more detail in order to arrive at some general quantitative rules for analysing financial structures.

The ratio of financial assets to total tangible assets

This basic ratio is described by Goldsmith as the financial interrelations ratio (F.I.R.)[3]. He states that this ratio is,

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2. This type of measure is similar to the one adopted by Gurley and Shaw in measuring the growth of indirect external finance in the U.S.A. See J.G. Gurley and E.S. Shaw, "Financial Intermediaries and the Saving-Investment Process", Journal of Finance, Vol. 11, March 1956, pp.257-276. Non-financial units in this context are, therefore, units involved in direct external finance or, obviously, internal finance.

3. R.W. Goldsmith, op. cit., p.26.

> ". . . obtained by dividing the total (partly duplicated) value of all financial assets in existence at one date by the total value of tangible assets plus net foreign balances, i.e. by national wealth . . ."[4]

The F.I.R. is used by Goldsmith to characterize financial structures - basically a low F.I.R. will indicate a financial system in the early stages of development and a high F.I.R. will indicate a very sophisticated financial system demonstrating a full range of financial instruments and institutions. In this latter case the F.I.R. may take a value in excess of unity, i.e. total financial assets exceed national wealth (income), whilst in the former case the F.I.R. may take a value nearer one-quarter or one-half.

What is being measured here is the total size of the financial sector, in terms of the total stock of indirect securities (to use Gurley and Shaw's term) in relation to the total stock of wealth - defined variously as we will see later on. Therefore the F.I.R. measures financial strength in terms of the more rapid growth of the financial sector vis a vis the real sector. In order to assess the value of this sort of measure in describing financial structures we need to examine in more detail the relationship between tangible wealth and financial assets both from a theoretical point of view (or perhaps more accurately a conceptual point of view) and from a quantitative point of view.

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4. R.W. Goldsmith, ibid, p.27.

There is little doubt that from an historical point of view a low F.I.R. characterized a number of economies in Western Europe in the eighteenth and nineteenth centuries. This stage of financial development saw the gradual replacement of metallic money by what Goldsmith terms 'scriptual' money (bank notes and demand deposits) and the increasing importance of commercial banks as financial intermediaries.

In addition this period is characterized by predominantly small family-owned businesses, where internal finance was pre-eminent. Given this situation how do financial intermediaries accelerate the rate of development. Morrison suggests that, as repositories of loanable funds, they can overcome financial bottlenecks which would exist in the internal finance situation.[5] A similar observation has been made by Cameron who suggests that the emergence of commercial banks will allow firms to switch from internal finance to indirect external finance and hence accelerate real development.[6] Cameron uses a simple example to illustrate this point. Let us suppose a firm earns 15% profit on annual turnover. Let us further suppose that 50% of gross profits are retained as working capital (Cameron suggests that the 50/50 splitting of profits was common during the early stages of industrial development in

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5. R.J. Morrison, "Financial Intermediaries and Economic Development: the Belgian Case", Scandanavian Economic History Review, 1967, p.59.

6. R. Cameron (ed.) Banking in the Early Stages of Industrialization, (London: Oxford University Press 1967) pp.11-12.

Europe)[7]. If a financial institution is able to provide short-term loans to replace internal working capital, then the proportion of gross profits going into investment will increase. This is assuming that there are viable investment projects available to the firm and that the rate of return on these investment projects is greater than or at least equal to the cost of borrowing short-term funds. Quite clearly a dearth of investment projects will not allow development to accelerate, so financial innovation (in terms of commercial bank intermediation) is a necessary but not sufficient conditon for accelerating development.

This line of argument pre-supposes that the appropriate innovative skills in a Schumpeterian sense are available to fully utilize the funds. This is why financial intermediation of this sort is described by Bennett as "innovative finance".[8]

The actual financial innovations may be very varied; but as Smith suggests, they can have a positive effect on economic development.

> ". . . Financial innovations can make financial instruments or markets more attractive and accessible to potential customers, changes in contract terms that make mortgage credit more attractive to home buyers, changes in services offered by a financial institution that make it more convenient, the shortening of

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7. R. Cameron, Ibid., p.12.

8. R.L. Bennett, The Financial Sector and Economic Development (Baltimore: The John Hopkins Press 1965) p.24.

> the interest payment period on savings instruments, or the development of a good secondary market are examples of innovations of this type. All of these changes result in shifts in the demand or supply schedules and in the amount demanded or supplied at given rates . . "[9]

The interesting point to be developed out of the preceding argument is that banks may assist firms in expanding investment without actually contracting medium-term or long-term loans with the firm. Morrison's analysis of financial intermediaries in Belgium in the 1830's emphasises a number of the points presented in this analysis. Here the innovative aspect of finance is stressed in the role of two specific financial intermediaries in the period. A brief statement on the development of these two intermediaries will help to illustrate how the innovations occurred. In 1822 the Société Générale de Belgique was founded as a commercial bank. It was empowered to accept deposits, insure currency, discount bills, make advances, deal in securities etc. - in fact all the functions we recognize in a commercial bank today. The second bank, the Banque de Belgique was founded in 1835 and like the Societe Generale was authorized to function as a commercial bank. Between them these two banks had by 1838 acquired direct participation in 55 <u>sociétés anonymes</u> (Limited liability companies) with a total capitalization of over 154 million francs.[10]

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9. P.F. Smith, <u>Economics of Financial Institutions and Markets</u> (Homewood: Richard D. Irwin Inc., 1971) p.262.

10. R.J. Morrison, <u>op. cit.</u>, pp.63-64.

The fact that these two banks and others were very willing to lend to corporate enterprises in this period resulted in a rapid expansion of output during the 1830's. The innovations from a financial point of view consisted in the direct participation in the sociétés anonymes, leading to the firms developing established lines of credit with the financial intermediary. Secondly the banks established new deposit facilities like the savings account which rapidly increased their deposit base. (The Société Générale experienced more than a doubling of savings deposits between 1835 and 1838). However, in 1838 the expansion was abruptly halted by the suspension of payments by the Banque de Belgique. This financial crisis was brought about by three factors: (a) intense competition between the two banks mentioned, resulting in (b) considerably illiquidity in both banks' portfolios, and (c) a general depression in economic activity. The crucial point to develop from this analysis is that although it is reasonable to assume that the F.I.R. increased during this period of Belgium's history, confidence in both the financial institutions and financial instruments lagged behind. This means that a simple increase in the F.I.R. should not be taken immediately as an indication of increasing financial sophistication. What is equally important is that the new methods of financing become totally acceptable to corporate enterprises. Thus our simple example of a firm switching from internal finance

to external finance would indicate an increase in the F.I.R. but may not immediately indicate that a new stage of financial development has been reached, as implied by Goldsmith.

Equally broad definitions of financial instruments and financial institutions assumes a certain homogeneity from a typological point of view. This type of assumption is essential to Goldsmith if he wishes to compare financial structures across countries by comparing F.I.R.'s. In fact, for an individual country, we may be concerned with describing specific financial characteristics unique to that country which make broad comments about financial development less applicable. As Klein has commented for the Indian case, when discussing the structure of an econometric model of India,

> ". . . Money and credit phenomena must be included in a way that reflects Indian institutions. This may well turn out to be quite different from the monetary structure of models in other economies . . ."[11]

Taking this point of view a bit further, it would seem to imply that no one set of equations describing money and credit phenomena can be applied across the board to a wide range of economies. Thus a general theory of financial structure is going to be very difficult to achieve, certainly via an analysis of F.I.R.'s.

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11. L.R. Klein, "What Kind of Macroeconomic Modelling for Developing Economies", The Econometric Annual of the Indian Economic Journal, Vol. XIII, No. 3, 1966, p.324.

In addition, as is pointed out by Goldsmith, the extent of government participation in the economy will influence financial structure.[12] We may observe a declining contribution made to the total volume of financial instruments by commercial banks as State financial enterprises increase their issues of financial instruments relatively to commercial banks.

A second characteristic of individual financial institutions, which may be extremely difficult to quantify, but may be important from a structural point of view, is the personal relationships developed between borrowers and officials of the financial institutions. In fact the training of personnel may be a very important element in the continuing development of the financial structure. An inability to deal with consumers' demands completely, even though financial resources are available, will lead to a sub-optimal rate of financial accumulation. In addition the level of expertise within financial institutions will ultimately be reflected in peoples' confidence in the institution. Poor management may lead to liquidity problems which may encourage people to diversify their bank portfolios to a considerable extent to protect themselves against loss.[13]

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12. R.W. Goldsmith, loc. cit., p.36.

13. A specific example of this is given in, J. Bharier, "Need for Reform - Iran", World Bank Survey, The Financial Times May 1972.

Unfortunately the quality of management within individual financial institutions is very difficult to quantify. Presumably the diminishing importance of specific institutions in the issue of new financial instruments over time may indicate poor management; but a decline of this sort could be explained in other ways.

The F.I.R. will be influenced not only by the total volume of financial assets and the influences we have developed over the last few pages; but also by the ways in which total tangible assets are defined. Goldsmith defines these as national wealth, which he equates with national output. In this way the F.I.R. becomes a relationship between a stock and a flow or a relationship between two flows if the additions to the financial stock alone are considered. In addition there is the very difficult statistical problem of assembling long-run data on national output. If the F.I.R. is to be used as a measure of rudimentary financial structures, for instance those in medieval Europe, then appropriate measures for national output in this period are necessary to make the measure meaningful. In practice it is only possible to consider developments in Europe and North America since the middle of the nineteenth century and for many developing countries probably only for a limited period in the twentieth century, due to the poor data on national output and on financial structure prior to these periods. This means that

descriptions of rudimentary financial structures in Europe must, at the best, be conjectural and, at the worst, misleading. The F.I.R. attempts to be a measure by which different types of financial structure can be ranked and compared. However, the measure suffers from the problems of long-run consistency of data and accurate comparisons of data across countries. It seems that on the quantitative aspects along the F.I.R. is a difficult measure to use to define types of financial structure. Equally from a conceptual point, it is doubtful whether financial strength can simply be gauged in terms of the ratio of total financial assets to national wealth. At least the time profile of all financial assets would have to be considered as we will see in the next section.

The distribution of financial assets between different financial instruments

The total stock of financial assets consists of a range of financial instruments. Goldsmith suggests that we need to distinguish between two basic types of instrument - claims and equity securities. Claims may be against,

> ". . . domestic financial institutions, claims against domestic non financial sectors and claims against foreigners . . ."[14]

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14. R.W. Goldsmith, op. cit., p.8.

On the other hand equities are,

> ". . . the evidence of fractional ownership in the net worth of a business enterprise. Net worth, in turn, is defined as the difference between the sum of a unit's real and financial assets and its liabilities . . ."[15]

For the U.S.A. for 1963 Goldsmith found that approximately 75% of all financial instruments are claims and of these 40% are issued by financial institutions. Thus in looking at financial structures we are concerned with the total issue of claims by financial institutions in relation to the issue of all financial instruments. The increasing role of the financial system in financing economic activity would then show up in the more rapid growth in the net issue of claims by financial intermediaries in relation to other institutions issuing claims, e.g. households.

Gurley and Shaw have been instrumental in analysing the growth of financial instrument issues and the effects these issues have on economic development. Equally they point to the simple fact that primitive financial arrangements may depress economic activity.

> ". . . the level of economic activity and the rate of its expansion are depressed by primitive financial arrangements that limit each spending unit's expenditure essentially to its income.[16]

They go on to establish that the creation of primary

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15. R.W. Goldsmith, Ibid., p.8.

16. J.G. Gurley and E.S. Shaw, Money in a Theory of Finance, (The Brookings Institution, Washington D.C. 1966) p.56.

securities (in this case securities issued by businesses and bought by consumers) will allow for the emergence of spending units capable of investing in excess of their own savings and of spending units lending their saved income by purchasing primary securities. Initially the development of primary securities is seen as a direct one between firms and consumers. If financial intermediaries accumulate the savings of surplus consumer units and issue their own securities which are bought by firms, then another dimension is added to the argument. In this case indirect securities have been added. The development of this sort of indirect finance means that financial intermediaries will accumulate a portfolio of security issues, and will become more important in terms of the total outstanding claims in the economy. The crucial question we need to ask is whether it makes any difference to financial growth how this portfolio is composed? The analysis of F.I.R.'s is basically an ex post one. It is possible to observe an increasing ratio of primary securities to G.N.P. over time for a large number of countries and from these observations it is perfectly valid to conclude that as countries increase their per capita incomes their financial systems become more diverse and sophisticated. The problem with this sort of analysis that it cannot isolate the causative and responding factors, i.e. does a higher level of G.N.P. generate more financial issues, or does a growing

financial system generate higher levels of G.N.P., nor can it say what would have happened under different financial regimes. It is this second problem that we now need to look at in more detail.

As the cash sector of the economy becomes more important, the use of commercial banking facilities becomes more widespread and for a very wide range of countries it has been found that the ratio of savings and time deposits to G.N.P. and per capita G.N.P. rises as G.N.P. increases.[17] At this stage a higher degree of specialisation begins to develop between savers and investors. Savers deposit funds with commercial banks and investors draw on these deposits with the banks. The banks, in part, bridge the alternative time horizons of savers and investors. If we assume, in general, that savers have a shorter time horizon than investors, then the commercial banks by being able to replenish deposits withdrawn by some savers with new deposits from other savers can extend loans to investors of a longer duration than would be possible in the absence of such an intermediary. However

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17. J.G. Gurley, "Financial Structures in Developing Economies", in Fiscal and Monetary Problems in Developing States, (Proceeding of the Third Rehovoth Conference, edited by D. Krivine) pp.102-103. Gurley cites data for 70 countries from 1953-1961 where the equation is $T/GNP = -3.528 + .980\ GNP/N$ (.102)

Where T = time and savings deposits,

N = total population.

commercial banks are also holders of money balances, which means that there is a liquidity constraint on the time profile of the bank's portfolio. It is this restraint which tends to create more specialisation in the financial market. Other financial intermediaries may develop which offer a longer time horizon to investors at the expense of creating more illiquidity amongst savers. Investors for their part issue primary securities to acquire tangible assets, and the financial intermediaries issue indirect financial assets to savers. So far we have not considered the issue of government debt. The government may finance its own activities in three ways; taxation, the profits from its own economic enterprises or by borrowing. The government may borrow by issuing primary securities which are purchased by financial intermediaries or it may create its own financial intermediaries and draw directly on the funds of savers. In either case the government is now in a position to influence the financial system. In general terms a shift by the government from one form of wealth holding to another, i.e. the purchasing of securities from the private sector in exchange for money, will affect the community's savings and the rate of interest.[18] This is dependent upon changes in the quantities of privately held securities

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18. L. Metzler, "Wealth, Saving and the Rate of Interest", Journal of Political Economy, Vol. 59, April 1951, pp.93-116.

rather than a change in the quantity of money. A change in interest rates may raise or lower the growth rate of output. This view supports the general conclusions of Gurley and Shaw when they state that a change in the ratio of inside to outside money will affect the real rate of interest and consequently the choice between present and future consumption and the growth rate of output.[19] Quite clearly there are a number of effects which will be generated by this initial disturbance, which will lead to adjustments among intermediaries. For instance in the case cited here an increase in the stock of nominal money held by the public will lead to a forcing up of the price level to a point where desired and actual holdings of cash balances are equal. Alternatively a desire on the part of the public to reduce deposits will lead to banks either holding excess reserves or reducing rates of interest on loans and hence income.[20]

The discussion so far implies that as an economy moves from one where scriptual money is predominant to one where, through financial intermediation, a wide range of financial assets and liabilities are created then the

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19. J.G. Gurley and E.S. Shaw, Money in a Theory of Finance, Washington: Brookings Institution 1960).

20. J. Tobin, "Commercial Banks as Creators of Money", in Banking and Monetary Studies, D. Carson (ed.) (Homewood Illinois, Richard D. Irwin, 1963).

impact of such a financial structure on real development becomes more complicated. Out of the numerous effects generated by this sort of change we need to concentrate on two in particular. Firstly, the impact of increasing indirect security issues on the saving/investment process and secondly, how a lack of investment demand may influence the distribution and types of indirect debt issued.

It is generally accepted that domestic savings can act as an important constraint on the rate at which capital accumulation takes place in a developing economy. Therefore, means of mobilizing savings and utilizing more efficiently the existing level of savings are an important aspect of the development process. Not only is the total volume of savings important, but also the location of savings deposits and the time preferences of individual savers. Location is important in the sense that if information is not available to individual investors on likely sources of funds, because of physical distances between savers and investors then the financing of investment will not take place. Equally, if the time preferences rates of savers are high, in that long-term saving is accorded a low priority, then this will shorten the overall time profile of the portfolio of investment opportunities. As was asserted in chapter One, the development of banks in a situation like this can have the effect of bridging distances (physically) between the individuals

and also can have the effect of extending the time profile of investment, by substituting short-term savings for long-term loans, subject to a liquidity constraint determined by the turnover rate of bank deposits.

From the point of view of savings, the emergence of financial institutions may increase the total volume of savings or may utilize more effectively the existing volume. The mere presence of a banking institution may encourage savings. As Lewis points out,

> ". . . Experience shows that the amount of savings depends partly on how widespread these facilities are; if they are pushed right under the individuals nose, . . . people save more than if the nearest savings institution is some distance away . . .[21]

However, such an encouragement to savings may be a once-and-for-all move and this may not generate a continual increase in savings. Indeed the presence of savings institutions may encourage people to save less. If we assume that the risk of total loss is reduced if savings are transferred from a tin box to a banking account, then this may cause people to allocate a smaller proportion of their disposable income to savings than hitherto.[22] Thus it would be unwise to assume that the mere presence of savings institutions will materially alter the total

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21. W.A. Lewis, The Theory of Economic Growth, (London: George Allen and Unwin 1963) p.229.

22. R.C. Porter, "The Promotion of the 'Banking Habit' and Economic Development", Journal of Development Studies, Vol. 2, No. 4, July 1966, pp.346-366.

volume of savings in the economy. What savings institutions can do is to provide a more economical means of transferring information about the total volume of savings available to potential investors than if it were left to each saver to seek out an investment outlet for his funds. As Brunner and Meltzer imply[23] and Clower makes explicit,[24] the increased information generated by the creation of specialised institutions releases productive resources for other uses. Hence savings institutions can economise on individuals' time by providing specialised services. Thus it is sufficient for financial intermediation to be effective if the existing volume of savings is distributed optimally in terms of all known investment projects, assuming such a distribution was not feasible previously for the reasons already mentioned. As Porter has commented,

> ". . . A greater number of bank offices can mean a greater fraction of the nations saving is channelled into investment through the mediation of the banking system which, in turn, may lead to a more efficient allocation of investment projects. In countries without a well-organized market for investable funds there may be a multitude of partially or even completely, independent markets . . .[25]

A similar idea to this is development by McKinnon who

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23. K. Brunner and A.H. Meltzer, "The Uses of Money: Money in the Theory of an Exchange Economy", American Economic Review, Vol. LXI, No. 5, December 1971, p.804.

24. R. Clower (ed.), Readings in Monetary Theory, Penguin Modern Economics Readings (London: Penguin Books 1969) pp.13-14.

25. R.C. Porter, op. cit., p.352.

discusses the problem of fragmentation in the domestic capital market. As McKinnon points out,

> ". . . fragmentation in the capital market causes the misuse of labour and land, suppresses entrepreneurial development and condemns important sectors of the economy to inferior technologies . . .[26]

The concept of the "fragmented economy" is obviously important in this context. Fragmentation exists when,

> ". . . firms and households are so isolated that they face different effective prices for land, labour capital and produced commodities and do not have access to the same technologies . . .[27]

This means that different groups within a society may be responding to different sets of relative prices for identical real resources and this will cause a misallocation of resources for the country as a whole. The financial system here acts as a filter for information about available resources and the total volume of financial instruments available, and, therefore, the financial system as such can influence the distribution and use of real resources.

The growth of financial intermediaries responding to the gradual monetization of the economy and the move away from direct internal and external finance will automatically imply that indirect external finance will increase in relative importance. Thus, as Gurley and Shaw have pointed

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26. R.I. McKinnon, Money and Capital in Economic Development, (Washington: The Brookings Institution 1973) p.5.

27. R.I. McKinnon, op. cit., p.5.

out, the ratio of indirect external finance to direct internal and external finance is an indicator of financial sophistication in an economy.[28] However, such a ratio as this tends not to emphasise the time profile of indirect security issues in the economy.

> ". . . Indirect securities . . . are claims on financial intermediaries, including the monetary system. These securities take the form of currency, bank deposits, shares and even bonds. Financial intermediaries stand between ultimate borrowers and ultimate lenders to acquire the primary securities of the former and to provide indirect securities to the latter . . .[29]

This basic description of the role of indirect security issues in financial development by Ott, following the Gurley and Shaw analysis, has nothing to say about the distribution of total claims as between various types of indirect securities issues. Quite clearly a financial system based primarily on currency and bank deposits is a very different system to one based on these and other less liquid issues, like bonds and shares. Whilst Ott goes on to describe the pattern of indirect security issues in Japan from 1878-1958, no conclusions are drawn about the possible impacts of different "hypothetical" compositions of indirect security issues, except that a fairly obvious distinction is made

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28. J.G. Gurley and E.S. Shaw, "Financial Aspects of Economic Development, American Economic Review, Vol. XLV, No. 4, September 1955, pp.515-538.

29. D.J. Ott, "The Financial Development of Japan, 1878-1958", Journal of Political Economy, Vol. 69, 1961, p.123.

between "monetary" intermediaries (Bank of Japan, commercial banks and savings banks) and "non-monetary" intermediaries (specialist banks, insurance companies, co-operatives, etc.).[30] Again, the implication here, as in section one of this chapter, is that broad measures of financial structure based simply on indirect security issues, say little about the effectiveness of such a financial system. It has already been established that for a total volume of savings to become more effective the financial intermediary must issue indirect securities which have a long maturation period than the primary securities paid into the financial system. This is essential if short-term saving deposits are to be converted into longer-term investment projects. Now if the indirect securities generated by the financial system do not acquire this sort of characteristic, then the effectiveness of such a system is diminished. Thus the time profile of indirect security issues is also important when looking at the total volume of financial assets in the financial system and their distribution between financial instruments. This additional dimension is recognized by Goldsmith when he says,

> ". . . The same total amount of financial instruments, even if it reflects the same financial interrelations ratio, may have quite a different economic significance and may affect economic growth differently depending on its composition - for instance the share of debt and equity instruments, of short- and long-term debt instruments, of marketable instruments, and of

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30. D.J. Ott, op. cit., p.130.

> more or less risky and price fluctuating instruments . . .[31]

So the total volume of financial assets is only one part of the complicated picture. Equally important is the distribution of financial assets between financial intermediaries.

The distribution of financial assets between financial intermediaries

Comparing the range of financial institutions in developed and developing countries today, one obvious feature manifests itself: the actual range or types of intermediaries tends to be greater in developed countries. This is a fairly obvious observation and the phenomenon results from the demand for more specialised lending institutions as development proceeds. The specialisms might range from preferences for geographical areas (agricultural credit banks), preferences for longer-term lending (industrial banks, building societies, etc) preferences for diversifying risk (unit trusts, insurance funds etc.). Therefore, over time, we would expect the range of financial institutions to broaden as the demands put upon the financial system become more intense and

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31. R.W. Goldsmith, loc. cit., p.27.

specialised. It must be emphasised here that this sort of argument is demand orientated. Quite clearly governments can create new lending institutions and hence expand the supply of indirect securities on the argument that,

> ". . . the need for specialised agencies for the finance of investment cannot safely be left to the processes of slow evolution. What in earlier generations could have been allowed to develop over scores, if not hundreds, of years must now of necessity be created in a much shorter space of time . . .[32]

Thus a financial system may be "imposed" in the sense that direct stimulation to its development may be given by the government. Apart from this sort of stimulation the arguments developed by Gurley and Shaw and Goldsmith do suggest that as the ratio of financial assets to tangible wealth increases over time, the range of financial institutions also increases. This is, primarily, because the demands from investors and the requirements of savers become more specialised. From an investors point of view there are considerable advantages to be gained from the development of financial institutions specialising in, say, the financing of a particular sector of industry, since highly specialised knowledge can be built up with the intermediary which can assist the investor in this decision-taking. Equally for the saver a wider range of financial

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32. E. Nevin, Capital Funds in Underdeveloped Countries, (London: Macmillan and Co. Ltd., 1963) pp.73-74.

institutions provide savings facilities of varying risk and time preference and hence choice is extended. These short comments on the benefits to savers and investors implies a certain two-way relationship between savers and investors and financial institutions. It is the desire of savers to diversify their portfolios, which will create more specialised savings institutions and it is the desire of investors to seek more specialised financial assistance which will lead to more specialised lending institutions. Thus the attitudes of savers and investors to the financial system will influence its development. Earlier in this chapter the question of innovative finance was discussed. This concept suggests that financial institutions can be innovators in the sense that they offer new services to investors or even participate directly in the investment process. The extent to which this latter point is important will be dependent on the legal structure of industry in the country concerned. Equally savers may not use financial institutions even though they may be aware of their advantages - there may be something of a "culture-bloc" operating here.

However,

> ". . . If the financial investiveness of the community (including its capacity and readiness to adopt financial innovations practiced elsewhere) keeps on generating new forms of financial assets and new financial arrangements, the frontier of intensive

financial growth keeps on shifting outward over time . . ."[33]

Gupta's use of the term "intensive financial growth" can be likened to the concept of "financial deepening" adopted by Shaw,[34] since both terms refer to the relatively faster growth of the financial sector over the real sector as development proceeds. If innovations in the financial sector do not occur then the resulting financial system mey be termed shallow (Shaw) or regressive (Gupta).

Shaw's concept of financial deepening is important in the context of the foregoing arguments, since it is the process of financial deepening (the more rapid growth of monetary assets over real assets) which puts financial development into a dominant place in development theory. This is a theme we will return to in Chapter Three.

Thus the type of financial structure which develops within an economy will be dependent partly on the "financial investiveness" of the community and partly on the demands by investors for more specialised financial assistance and the desire of savers to diversify their own portfolios, both in terms of risk and in terms of time preference. This illustrates the nature of the two-way relationship referred

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33. S. Gupta, "Financial Progress, Banking Expansion and Saving", Indian Economic Journal, Vol. XX, No's 4-5, April-June 1973, p.562.

34. E.S. Shaw, Financial Deepening in Economic Development (New York: Oxford University Press 1973).

to earlier.

The discussion so far suggests that the size and functions of the financial system will depend on the demands put upon it by the real sector and the extent to which the financial sector itself has any innovative characteristic within it. Emphasis has been laid in this chapter on one particular approach to analysing financial structures and the concomitant effects on economic development. This approach, via an analysis of total financial assets and their distribution, seems to subordinate a number of specific characteristics of financial structures which may be very important in the development context. It is to the question of these further characteristics that chapter Three addresses itself.

C H A P T E R T H R E E

The Financial Sector and the Financing of Economic Development

The preceding two chapters have attempted to illustrate the inter-relationships between financial growth and economic development and to analyse specific measures of financial growth. Taking Goldsmith's measures of financial growth, then a situation where the F.I.R. is in excess of unity implies an economy moving into the fully-developed stage. However, using Shaw's concept of shallow finance suggests that the total volume of financial assets, alone, cannot determine financial growth. It is the diversified nature of financial assets which is also important. This chapter attempts to bring these two approaches together and also introduces a new dimension to the argument: a situation where financial institutions acquire assets in more than one currency. It will be demonstrated that when this dimension is added then even a synthesis of the Goldsmith and Shaw views do not adequately describe financial growth or financial deepening.

The emphasis so far has been on an analysis of the total volume of assets and the distribution of these assets

amongst financial institutions, as indicators of financial structure. However, financial structure may be characterised in a number of alternative ways. Kurosaki's analysis of finance in underdeveloped countries points to at least six characteristics that might be important: (i) the existence of a non-monetary sector; (ii) the definition of organized and unorganized money markets; (iii) the importance of trade in the financial system; (iv) the development of capital markets; (v) the seasonal characteristics of finance; (vi) the duality of the interest rate structure.[1] By examining these characteristics in turn we can establish a number of other factors which might influence financial structure.

1. The Size of the Non-monetary Sector

It appears to be generally assumed that as economies become more specialised in their productive activities and in their trading arrangements, then the use of a specific money commodity becomes adopted and exchange takes place in terms of this commodity rather than in terms of the goods themselves.[2] Hence the use of notes and coins is adopted and from this develops a banking system, since

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1. H. Kurosaki, "Characteristics of Finance in Underdeveloped Countries", Developing Economics, Vol. 1, No. 3, 1963.

2. R. Clower, Introduction to, Readings in Monetary Economics, (Penguin Modern Economics 1969) pp.13-14.

excess cash balances can now be deposited in the banking system to be recycled for investment purposes. However the emergence of a money commodity is dependent on the prior emergence of exchange relationships. If units in society are self-sufficient in production and consumption and are sufficiently isolated for specialisation in production not to occur, then the need for a money commodity does not arise. Typically the agricultural sector in many developing countries is characterized in this way. Peasant farmers are basically self-sufficient and what trading there is is done on a barter basis. Thus the agricultural sector is non-monetized. This in itself creates a stumbling block to development since it does not allow for the easy transfer of capital out of the agricultural sector to other sectors, since this capital is denominated in real goods. The size of the agricultural sector in total output terms and the extent of its monetization is going to influence the extent to which financial assets circulate within any one country. Taking an extreme point, it is possible to envisage a dual economic system in existence, possessing a monetized sector and a non-monetized sector, with no financial "bridge" operating between the two. One typical measure of the degree of monetization is the ratio of currency to G.N.P., and for many developing countries it has been observed that this ratio tends to decrease as more sophisticated credit facilities become available in rural areas. However, an

increasing ratio of currency to G.N.P. might also indicate increasing monetization in that currency may be replacing real goods in economic exchanges. Comparative data prepared by Korum indicates both of these trends for a selected number of middle-eastern countries,[3] which makes such a measure very difficult to interpret. Certainly the size of the non-monetized sector and its geographical isolation from other sectors in the economy can act as a considerable drag on financial development and thus on real output growth; but this constraint is extremely difficult to quantify in any meaningful way.

2. Organized and Unorganized Money Markets

> ". . . The organized sector in the developing countries does not represent an organic entity. Organized and unorganized money markets exist in these countries. The existence of unorganized money markets is an obstacle to economic development, since they do not help in the accumulation of capital funds, neither can their financial assets be used and invested in those areas where the need of development is greatest . . . The existence of such unorganized money markets means a narrowness of the organized money market."[4]

The existence of a number of money markets through which individuals operate leads to fragmentation in the process

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3. S. Korum, "Financial Structure, Economci Growth and Monetary Policy in Turkey", in Central Banking, Monetary Policy and Economic Development, (CENTO Symposium held in Izmir, Turkey, April 1971) p.124.

4. S. Korum, op. cit., p.124.

of capital accumulation and to a slower rate of capital accumulation than would exist if unification of money markets was feasible. The more rapid rate of capital accumulation generated through unification will then help to accelerate the rate of economic development assuming that investment opportunities are available. As McKinnon point out;

> ". . . The . . . unification of the capital market, which sharply increases rates of return to domestic savers by widening exploitable investment opportunities, is essential for eliminating other forms of fragmentation . . ."[5]

Bearing these general points in mind, it has to be conceded that this type of fragmentation is very difficult to characterize and quantify. One indicator which has been used extensively is the total money supply. The existence of a banking system, and the use of this system by individual depositors indicates some specific type of organization, and if the ratio of total bank deposits to the money supply increases at a rate greater than the rate of growth of real income, then it can be assumed that more people are depositing savings into this organized system.[6] Thus the organized money markets grow at the expense of unorganized

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5. R.I. McKinnon, Money and Capital in Economic Development (The Brookings Institution, Washington D.C., 1973) p.9.

6. If deposits kept pace with the growth in real income, and the marginal propensity to save was constant, then an increasing ratio of deposits to total money supply would not necessarily indicate that more use was being made of the banking system, i.e. more use, in terms of more people.

money markets and a greater volume of monetary assets is channelled through these markets.[7] Organized money markets also reduce the costs of information and risk to the individual investor. Where unorganized markets exist the costs of searching for loanable funds may be prohibitive as it may require the accumulation of information on a number of organized markets. Presumably in an organized market this search cost will be reduced.[8] Equally the transferance of resources from unorganized to organized markets will have the effect of increasing the efficiency of any given total of these monetary resources, in that knowledge about the range of potential investors will be greater in the organized market and, hence, the risk involved with respect to each investor will be reduced.

3. Trade and Financial Development

In a survey of middle eastern banking conducted by Ronall in 1962, it was reported that in many cases, over two-thirds of all loans by commercial banks were distributed to the trade sector.[9] This sort of distribution

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7. U. Tun Wai, "Interest Rates in the Organized Money Markets of Underdeveloped Countries", International Monetary Fund Staff Papers, Vol. V, No. 2, August 1956, p.249.

8. This point is established more formally in Chapter One.

9. J.O. Ronall, "Recent Banking Developments in the Middle East", The Bankers Magazine, Vol.CXCIII, No. 1418, May 1963, p.419.

is not difficult to explain and is, in fact, repeated in other developing areas of the world. Trade loans tend to be short-term and the security available in terms of the throughput of goods is quite considerable. If this is compared with investment within the nascent industrial sector of a developing country, where the risks of default may be considerably higher then it is not surprising that commercial banks should have this preference for trade loans.[10] From a borrowing point of view, the emphasis on commercial loans is also important. Initially deposits into the banking system tend to be short-term in character, as people use the banks as a repository for short-term surplus funds, and therefore this is complemented by a generally short-term loans portfolio. Ronall's observation about the structure of total loans referred to 1962; but more than a decade later the situation is not much different, for a number of selected countries as can be seen from Table 3.1.

As Table 3.1. shows, the importance of the commercial sector, in these selected middle eastern countries, in terms of the use of commercial banks has not diminished

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10. C.V. Brown reported that indigenous banks in Nigeria anticipated up to a 25% default rate on industrial loans in Nigeria in the 1950s and early 1960s. See C.V. Brown, The Nigerian Banking System, University of Glasgow Social and Economic Studies, New Series No. 8 (London: George Allen and Unwin 1966), Chapter 3.

Table 3.1. The percentage distribution of loans to the commercial sector in selected Middle Eastern countries, 1960 and 1973

Country	1960	1973
Iran	77	44
Lebanon	40	53
Libya	48	40
Sudan	80	57
Syria	64	79
Turkey	39	68

Sources: 1. For 1960 data see J.O. Ronall, op. cit.

2. Sudan, Bank of Sudan, Thirteenth Annual Report, December 1972.
Iran, Bank Markazi, Annual Report, 1973 - this gives data for private sector commercial loans only.
Syria, Banque Centrale de Syrie, Economic Bulletin, June 1974.
Turkey, Turkiye Cumhuriyet Merhez Bankasi, Aylik Bülten, December 1973.
Lebanon, Banque du Liban, Annual Report, 1973.

Notes: The figure for Sudan in 1960 contained export financing for cotton and gum. The figure for 1973 is not as comprehensive.

over the last decade. This continuing bias towards commercial loans is not surprising. As Nevin has commented;

> ". . . certain limted sectors of the economy (typically the export of primary produce) will hold out sufficient profit expectation to ensure that adequate finance is forthcoming from banks and other sources; for the rest of the economy, however, profit outcomes are so uncertain and far-distant that private capital is reluctant to flow into it of its own volution . . ."[11]

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11. E. Nevin, Capital Funds in Underdeveloped Countries, (London: Macmillan and Co. Ltd., 1961) p.74.

Thus the continuing importance of commercial loans is one indicator of the lack of penetration of the commercial banks into the industrial sector. In some sense a type of vicious circle works here. The industrial sector, in order to grow, requires external financial assistance. This assistance is not forthcoming as the industrial sector is regarded as being too risky in terms of the time profile of loans required. Hence the potential of the industrial sector is not realized. The financing of industry requires loans which are at least medium-term in nature and is, therefore, very much dependent on the emergence of a long-term capital market to provide these facilities.

4. The Development of Capital Markets

The increased use of financial intermediaries brings about what Patrick refers to as an "improvement in the composition of wealth".[12] This improvement occurs as a given volume of financial assets are utilized more efficiently through the reduction of uncertainty and the increased flow of information between savers and investors. This means that a given volume of tangible wealth can become more productive, or alternatively for a given volume

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12. H.T. Patrick, "Financial Development and Economic Growth in Underdeveloped Countries", Economic Development and Cultural Change, Vol. 14, January 1966, pp.181.

of investment a lower volume of tangible wealth is necessary. Taking this second point further, the surplus wealth invested into the financial system may increase investment over a longer time period, as Patrick notes;

> ". . . newly developed access to funds on reasonable terms from financial institutions can induce or encourage entrepreneurs to expand their horizon of conceivable opportunities . . ."[13]

Thus the re-investment of the surplus tangible wealth can have the effect of extending the time horizon of investment and thus can help to stimulate the growth of longer-term capital markets. Such a development is, however, dependent on the reduction in uncertainty in financial markets and the concomitant reduction in effective interest rates, thus making viable in a present value sense, more and more investment projects.

The degree to which long-term capital markets exist in a particular country is one measure of the extent to which medium and long-term finance is available to the industrialist. Perhaps more to the point, it is the absence of long-term capital markets which has encouraged the development of specialised industrial and agricultural investment banks. The creation of such institutions is usually due to pressure from two specific sources. Firstly many governments in developing countries feel that they cannot wait for such institutions to develop naturally as the financial system evolves. Secondly, the sectors of the

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13. H.T. Patrick, op. cit., p.185.

economy in need of specialised financial assistance often do not have the conventional characteristics of high profitability and low risk to attract commercial bank funds. As Nevin concludes,

> ". . . an economy is under-developed precisely because the greater part of its productive capacity has not proved an attractive investment for private funds; institutions to channel funds into those sectors have therefore failed to evolve from the spur of orginary market forces. Hence if the savings available to the community . . . are to be used to attain maximum growth in the economy, the institutional framework to assist and stimulate the flow must be deliberately created and supported by the government of the territory concerned. To leave this task to unassisted market forces is to incur a serious risk that it will not be performed except after intolerable delay . . ." [14]

Thus the creation of specialised financial institutions, under some governmental or international patronage, is, in itself, an indication of the potential deficiencies of natural financial growth.

5. The Seasonal Characteristics of Finance

The existence of large agricultural sectors, in output and employment terms, and industries processing agricultural goods in many developing countries means that certain seasonal fluctuations are likely to occur in the financial sector. The annual or bi-annual sale of crops will boost cash reserves within the banks, which will then be gradually depleted over the growing season. This seasonable variability in cash flow probably means that cash reserves have to be kept artificially high at certain periods in the

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14. E. Nevin, op. cit., p.74.

year; thus reducing the loans made available by the banks.

A number of specific examples of this seasonal variability in cash supplies is given by Jucker-Fleetwood for six African countries.[15] The monoculture agricultural systems, especially in Ghana, meant that annual fluctuations in the money supply could be as great as 40% (in the case of Ghana) in the early 1960's. Thus seasonal fluctuations in cash mitigate against the optimal utilization of funds in medium and long-term markets. These seasonal characteristics will presumably become less important as the contribution of the agricultural sector, in relative, terms, to national output declines. However, in the early stages of development, seasonal fluctuations in financial transactions may be an important explanation of the levels of cash balances held by the commercial banks.

6. The Duality of the Interest Rate Structure

Just as money markets may be "organized", "unorganized" or "fragmented", so a dual system of interest rates may be an important characteristic of such markets. Although different interest rates do exist in highly developed money and capital markets, they normally reflect the alternative time preferences of individual investors and

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15. E. Jucker-Fleetwood, Money and Finance in Africa, Basle Centre for Economic and Financial Research. Series B, No. 6 (London: George Allen and Unwin Ltd., 1964) pp.74-82.

the risks associated with particular assets. In less well developed markets different interest rates may reflect not only the availability of funds but the fragmented nature of financial markets, where the existence of imperfect information may mean that different prices exist for a single monetary asset. It is this uncertainty which fragments the financial system such that no one interest rate reflects the community's collective time preference.[16]

As Bennett points out,

> ". . . The financial markets in the traditional economy are highly personalized, so that changes in interest rates on borrowed funds would be ineffective as stimulants to increased savings or redirection of the uses of past savings. Each interested household has a particular firm or group of firms and a particular financial institution to which its savings are made available. Each firm has particular interested households and a particular financial institution from which it can obtain funds . . ."[17]

Thus a whole range of interest rates may exist in small "personalized" and separate markets. Thus any analysis of interest rates conducted in terms of uncertainty alone will only be able to assimilate half the problem. There may be perfect certainty in each separate market, yet different interest rates for identical assets may exist because of the geographical isolation of each market and because of

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16. R.I. McKinnon, loc. cit., p.16.

17. R.L. Bennett, The Financial Sector and Economic Development, (Baltimore: The John Hopkins Press 1965) pp.24-25.

its unique set of participants, as observed by Bennett.

Of course the most obvious case of duality in interest rates is that between "official" Central Bank and commercial bank rates and those rates charged by money lenders. Again the different rates exist, not because of any specific characteristics of the assets being offered; but because of the heterogeneity of those requesting loans, in terms of the subjective view lending institutions have of their ability to repay the loan. A particularly good example of the working of such markets is given by Fry for Afghanistan.[18] Although much of the discussion concerns the role of the money bazaars in financing foreign trade, some of the points made are germaine to this discussion on interest rates. One of the great attractions of the bazaar is that an individual trader can get a loan whenever he requires one and with very little administrative difficulty. The lack of administrative difficulty, in contrast to the regulated interest rates within the formal banking sector, has meant that interest rates in the bazaar have tended to decline as the rates in the formal banking sector have risen, thus repressing financial growth. This points to another aspect of this duality of interest rates. The control of interest rates by the Central Bank may have the

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18. M.J. Fry, Kabul and Kandahar Money Bazaars: Their Role in Afghanistan's Foreign Trade, (Kabul: United States Agency for International Development, June 1973).

effect of diverting resources from the commercial banks into the bazaars. For instance, interest rates on loans in Afghanistan have always discriminated in favour of the public sector (2% - 5% in the 1960's) against the private sector (6% - 8% in the 1960's). This has the effect of either driving out private sector investment or causing investment in higher risk activities to occur in the private sector.

Interest rates have an important role to play in a developing economy. As Chandavakar points out,

> ". . . interest rates can be viewed as instruments for more effective mobilization of savings (deposit rates) through the offer of realistic rates on monetary savings, such as time and savings deposits, claims on financial institutions, and government securities. Similarly, interest rates can be viewed as a social rate of discount to determine the optimum allocation of savings between consumption and investment and as a rationing device for efficient allocation among alternative forms of investment . . ."[19]

The mobilization of savings into formal markets, increasing information and reducing marginal costs, reduces rates of interest and raises the marginal efficiency of capital. Thus the duality of the interest rate structure is in itself a drag on financial growth.

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19. A.G. Chandavakar, "Some Aspects of Interest Rate Policies in Less Developed Economies: The Experience of Selected Asian Countries", International Monetary Fund Staff Papers, Vol. 18, No. 1, March 1971, pp.49-50.

The arguments presented under the preceding six headings indicate that financial growth may be constrained by a wide range of factors, some more tangible than others. The measures of financial growth used both by Goldsmith and Shaw comprehend some of these factors; but certainly not all of them. Quite clearly not all these factors operate with equal force in every country; but in the case of Lebanon there is sufficient evidence to suggest that many of these factors may be important. In Part II evidence will be presented on the degree of monetization in the economy, the operation of unorganized markets; the heavy concentration in the banking sector on commercial loans; the absence of a medium- and long-term capital market and the duality of the interest rate structure. Seasonal fluctuations in finance is probably the only factor which is not important in Lebanon. The presence of these factors, it will be argued, has inhibited the development of financial instruments for industrial development. Thus, although the ratio of financial assets to national income in Lebanon is well in excess of unity, the whole financial system has played little part in the domestic fixed capital formation. Apart from the factors mentioned above the presence of foreign currency deposits and foreign banks in the financial system has also been decisive.

Foreign Currency Deposits and Foreign Banks

Whilst the presence of foreign banks in many developing countries is clearly recognizable, it is more difficult to identify the ways in which foreign banks uniquely affect financial growth. The development of foreign banking in developing countries has no single factor behind it. Certainly in the nineteenth century trade between Western Europe and Africa, South America and Asia stimulated the growth of foreign banks in many countries to facilitate payments between raw material suppliers and the industrialising markets of Europe.[20] In addition foreign banks through their expertize and overseas financial backing have been able to secure deposits at source for repatriation to overseas money markets such as London. Thus a traditional view of foreign banks would be that they have little interest in the domestic economy other than ensuring that new deposits become available from the domestic economy which can then be used more productively in overseas markets. This view is well exemplified in the comments made by Mars of foreign banks ("extra territorial" banks as he called them) in Nigeria at the end of the Second World War,

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20. Whilst the financing of trade was not the only reason for the growth of foreign banks it was a very important factor. See D. Joslin, A Century of Banking in Latin America, (London: Oxford University Press 1963) p.18.

> ". . . Since intra-territorial banks would be primarily interested in the internal development of the country, they would be more eager to create conditions enabling them to lend to Africans than the extra-territorial banks. These naturally concentrate on external trade; and, to the extent that they are interested in the profitability of existing investments in the United Kingdom, they are probably more anxious to preserve the present industrial structure of Great Britain, by retaining colonial markets for British export goods, than to develop secondary industries in Nigeria and elsewhere . . .[21]

Inevitably all foreign banks have close connections with their own countries of origin. For instance, many of the foreign banks of British origin maintain their head offices in London and these banks are integrated into the British banking system through joint ownership. Equally, British banking traditions and the use of the London money market for short-term funds will influence the way in which foreign banks operate in overseas territories. The description given by Mars of developments in Nigeria coupled with similar comments from many other countries would suggest that foreign banks will only have a superficial effect, at most, on financial growth in developing countries. The emphasis on the finance of trade and the use of overseas money markets really put foreign banks in an enclave situation, thus their effects on domestic developments were

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21. J. Mars, "The Monetary and Banking System and Loan Market of Nigeria" in Mining, Commerce and Finance in Nigeria - the second part of a study entitled The Economics of a Tropical Dependency by P.A. Bower, A.J. Brown, C. Laubscher, J. Mars and Sir A. Pim (London: Faber and Faber Limited, 1948) p.208.

bound to be limited.[22] Many of the studies related to the development of foreign banks tend to emphasise the point that as domestic monetary controls become more restrictive (typically this is associated with the establishment of a Central Bank) and as the size of the domestic market grows then foreign banks tend to lose their enclave status and become more integrated into the domestic economy. However this type of argument suggests that foreign banks do not provide innovative finance, in the sense that the term has already been used in this thesis. In other words they are responding to pressures put upon them by legal and commercial developments. This view contrasts rather strongly with that of Goldsmith when he says of the role of foreign banks,

> ". . . There is no doubt that the transmission of financial technology, as well as the more far-reaching establishment of new institutions by foreigners has played a large part in the financial development of most countries . . . . There is little doubt that . . . the establishment by foreigners of commercial banks, and to a lesser extent of central banks, has been the most important single influence . . ."[23]

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22. The literature on foreign banking, especially in Africa, is quite large and a sample, which subscribes to this view, would include, C.V. Brown, op. cit., W.T. Newlyn, Money in an African Context, Studies in African Economics No. 1 (Nairobi: Oxford University Press 1967); A. Basch, Financing Economic Development, (New York: The Macmillan Company 1964); E.E. Jucker-Fleetwood, Money and Finance in Africa, op. cit.

23. R.W. Goldsmith, Financial Structure and Development, Studies in Comparative Economics No. 9, (New Haven: Yale University Press 1969) pp.360-361.

Goldsmith goes on to admit that the volume of evidence on individual countries and the data for international comparisons is very limited. However, he suggests that foreign banks became predominant in the nineteenth century for the reasons advanced earlier in this chapter and more recently have tended to decline in absolute importance as domestic financial institutions have developed. The suggestion here is that the mere presence of foreign banks has done something to stimulate domestic financial growth, as Goldsmith goes on to suggest,

> ". . . Foreign banks have in most countries played a decisive role in introducing deposit and investment banking and in nursing it over its first difficult stages of adaptation to an environment differing very much from that of the Western European homeland. Secondly commercial banks have in many of these countries exercised a far-reaching influence on commercial and industrial development, in particular on foreign trade and thus have indirectly extended the influence of foreign shareholders and managers far beyond the immediate sphere of the activities of foreign banks . . .[24]

The thrust of Goldsmith's arguments concerns the role of the transference of financial technology; a transference, he suggests, achieved far more easily than the transference of agricultural and industrial technologies. Financial expertise, however, can be double-edged. There is no doubting the fact that personnel employed in foreign banking concerns will almost certainly, in the first stages, hold a comparative, if not absolute, advantage over their domestic

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24. R.W. Goldsmith, op. cit., pp.366-367.

counterparts. If this is coupled with the large overseas financial backing available to foreign banks, then the average and marginal costs of operating branches in developing countries will be less for foreign banks than domestic banks.[25] So foreign banks come into a specific country with a comparative advantage over local institutions. This advantage derives from their global size and from the general level of expertise in the banks. Now it could be argued that this is a desirable development in that competition between banks will raise the efficiency of all of them and local banks will benefit from the examples set by foreign banks. However, the following question could be posed - why does the foreign bank enter the market in the first place? - almost certainly not to provide small scale loans to merchants and craftsmen but rather to capture deposits at source for re-investment in Europe and America. Thus the foreign bank element can co-exist with the local bank element and yet not assist in its internal development. This is obviously inclining to the enclave view of foreign banking developments.

If foreign banks concentrate on trade finance and the repatriation of excess funds to overseas money markets, then indigenous banks are left to deal with the problems

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25. This is assuming that a learning by doing process is in operation, with the foreign banks operating on a lower portion of the learning curve.

of the emerging demands for industrial and agricultural credits domestically. If the usually lucrative and short-term commercial loans are denied to them, then local banks are very easily in danger of developing, a high-risk, illiquid and undiversified portfolio of loans. This point is emphasised here since it constitutes the basis for a wider range of arguments in Part II on Lebanese banking developments. In Part II it is contended that in Lebanon the financial system has been dichotomized with foreign and indigenous banks adopting seperately the functions described briefly above.

It is a pity, in a sense, that Goldsmith tells us nothing, explicitly, about what he means by the term "financial technology", since it would help in understanding why he thinks it is so important and why it has had the positive effects asserted for it. Presumably the entry of a foreign bank into a financial system introduces banking practices possibly alien to the existing indigenous banks. The very success of the foreign bank, which, incidentally, may have nothing to do with the technologies employed by it, may encourage local banks to emulate it. This might involve specific re-training programmes for personnel or the adopting of specific methods of banking practice, i.e. accounting methods, the use of certain types of collateral, methods to encourage increased savings through bank deposits. In all these cases it is possible to

hypothesise that the foreign bank has a stimulating effect on local banks, in that the financial technology embodied in the foreign bank is somehow passed on. But is financial technology a free good? - presumably not. If a foreign bank enters the market it will attempt to maintain any advantage it has by restricting information and will not act in the philanthropic way suggested above. Thus new financial technology may be embodied in the foreign bank but not passed on, unless domestic monetary control is sufficiently strong to be able to standardize procedures between banks. Thus monetary control may be important in reducing the dichotomy in lending and borrowing practices mentioned earlier. This is a point we will return to in more detail in chapter Eight.

It must also be recognized that in a developing financial system a foreign bank may be a very attractive magnet for domestic funds. Individual savers, quite rightly, will assume that the foreign bank is larger and more firmly secured than the newly-emerging local banks and hence will deposit their funds in the foreign bank. Even higher interest on deposits offered by local banks may not have the effect of shifting funds.[26] Then the higher interest rates offered by local banks have to be offset by loans

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26. A specific example for Lebanon in the 1930's is given in S.B. Himadeh, The Monetary and Banking System of Syria, (Beirut: American Press, 1935) p.180, where local bank deposit rates were some 50% higher than foreign bank deposit rates.

with a high expected rate of return and hence a high risk.[27] Such a process as this is not likely to stimulate the growth of indigenous banks and will, in all probability, suppress them.

Finally in this chapter we need to turn our attention to the effect that foreign currency deposits have on financial growth. Goldsmith's discussion of the role of foreign banks makes no mention of foreign currency deposits. This is probably not surprising, since most of his attention was being focussed on Africa, Latin America and some parts of Europe. Here foreign banks were securing domestic currency deposits in the main. In the Middle East today and especially in Lebanon, the situation is somewhat different. States receiving oil revenues normally receive them in either sterling or dollars. In addition many trade transactions take place directly in a foreign currency, rather than through the intermediation of the domestic currency. This means that banks have collected deposits denominated in other currencies than local currencies. We will go on to show, in chapter Seven, that in Lebanon foreign currency deposits now account for over 60% of total bank deposits. The presence of these sorts of deposits in a banking system have a number of effects. Firstly, the ability to finance domestic activities is restricted since there is a foreign exchange risk involved in expanding domestic credit on the basis of foreign currency deposits.

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27. Here risk is measured in the usual way for portfolio analysis as the standard deviation or variance of the possible outcomes.

What domestic credit expansion there is will presumably have an exchange risk premium attached to it, which will raise the cost of loans to the domestic economy. Secondly, many foreign currency deposits may be short-term in nature in that, as foreign currency deposits, they are deposited in Middle Eastern Banks with the intention that they be moved into European and American money markets as soon as possible. Thus middle eastern banking systems, and this is certainly relevant in Lebanon, simply become short-term repositories for foreign currency deposits. This forces many banks to hold cash and liquid reserves well beyond the level that would be necessary in a single currency case Again, the many problems associated with defining liquidity in these cases are dealt with in chapter Seven. Thirdly the presence of foreign currency deposits make monetary control more difficult. Domestic monetary policies affecting the liquidity of the banking sector may have a foreign exchange effect, in that depositors, in many cases not nationals of the countries concerned, move their deposits in response to the monetary control. For instance any legislation by the Central Bank in Lebanon to try and reduce the turn-over on foreign currency deposits, traditionally reported as being higher than that on domestic currency deposits, possibly to encourage more domestic credit expansion,could have the effect of causing the withdrawal of foreign currency deposits.

Thus the presence of foreign banks and the denomination of deposits in foreign currencies add further dimensions to this general question of the relationships between financial growth and economic development. Generally speaking whilst foreign banks have the affect of "internationalizing" the financial sector they also introduce the dichotomy between commercial and industrial finance which tends to disadvantage the indigenous banks. Secondly the presence of foreign currency deposits means, in general terms, that the total volume of bank deposits in the financial system probably over-estimate the domestic credit expansion ability of the financial sector, since banks will have a tendency not to become "fully loaned-up" on their foreign currency deposits.

Goldsmith, in reviewing the growth of financial intermediaries and new financial issues in fourty-six developed and developing countries in the period 1949-1967, came to many conclusions about the way the financial system was related to national product; but the following conclusion is a very important one in the context of the arguments presented in this chapter. He argues that,

> " . . . institutional factors and historical accidents play a considerable role in determining both the level of the ratio of financial institutions to national product and still more so in the distribution of the total assets of financial institutions among the main types of them . . . The influence of institutional or accidental factors appears to be even more pronounced among less developed countries and it would

> require a country-by-country investigation of their financial development to be able to explain the differences . . .[28]

It is precisely this country-by-country approach which will be adopted in Part II, where the development of the financial sector in Lebanon is documented and the growth of the sector is related to economic development in the country.

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28. R.W. Goldsmith, "The Development of Financial Institutions During the Post-War Period", Banco Nazionale del Lavoro Quarterly Review, No. 97, June 1971, pp.172-173.

P A R T II

C H A P T E R F O U R

A Profile of the Lebanese Economy 1950-1974

The theoretical relationships between financial growth and economic development developed in Part I can now be extended and applied to the Lebanese economy. To understand fully the factors which have influenced financial growth in Lebanon and the factors which have determined the rate of economic development, it is necessary to provide a clear description of recent developments in the Lebanese economy. This chapter is concerned primarily with the structural changes that have occurred in the components of national output in Lebanon between 1950 and 1974. The choice of 1950 is somewhat arbitrary, but it does coincide with the first appearance of some basic aggregate statistics on the economy and with the beginning of the emergence of the banking system that exists in Lebanon today.

Particular emphasis is placed in this chapter on the apparent instability created by the relatively small contributions of agriculture and industry to national output. In addition the provision of financial services and the level of government expenditures are highlighted as potential obstacles to more rapid and diversified development in the future. This chapter also serves as a general introduction

to the more detailed analysis of the growth and development of the financial sector contained in the following five chapters.

A somewhat glib view of Lebanese economic development would suggest that the national character of the Lebanese combined with certain geographical and historical factors has produced a predominantly trading economy, with considerable emphasis being placed on quick returns. Alternatively the apocryphal story of an international economic expert visiting Lebanon in the 1950's who was reputed to have said, 'I don't know how it (the economy) works; but it does, so leave it alone', also indicates that not only is the economy geared to quick returns, but anyone attempting to analyse it is doomed to failure.[1] This view probably had some truth in it when basic aggregate economic data was totally unavailable; but now some data is available which makes some analysis of recent trends possible. However, there is a need to be mindful of the following comment in a handbook produced for the American government on Lebanon in 1968,

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1. This story is reported in one form in C.P. Kindleberger, Economic Development, 2nd edition (Tokyo: McGraw Hill Book Co. Inc., 1956) p.231.

> ". . . Analysis of the economy is hampered by a lack of essential statistics. The last population census was taken in 1932. The only official set of national accounts was completed in 1967 for the year 1964. Balance of payments information is published with several years' delay. These and other published statements are largely based on estimates, because basic data are not being collected. The economic statistics are therefore to be considered only as approximations."[2]

It is true that the data available does not permit of intensive analysis; but what is available is very useful in indicating broad trends and changes in economic activity. The analysis presented in this chapter will concentrate on a period of rapid economic growth, over the last twenty-five years.

Lebanon with a land area of 10,400 square kilometres occupies a slightly unusual position in the present Middle East. Its long history has brought together numerous minority groups, both religious and ethnical. The mountainous terrain has allowed these minority groups to survive to the present day and to maintain their individuality. The country is largely dominated by Christian and Muslim groups, who, although supposedly representing 50% of the total population each, are in fact fragmented internally. Between these two major groupings are one or two distinct minority groups; the most important being the Druzes (about

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2. H.H. Smith, (Editor), Area Handbook for Lebanon, DA Pamphlet No. 550-24 (Washington: U.S. Government Printing Office, 1969) pp.213-214.

6% of the population). The relationships between the major religious groups is an important element in political life and the Lebanese political system has evolved in such a way as to provide representation on the basis of religious groups rather than political views. A further important influence on Lebanese life is the very large number of emigrants living in other parts of the world. It has been estimated that more Lebanese live outside Lebanon than inside. If this is true, the total number of emigrants probably exceeds 3 million. These emigrants contribute to the Lebanese economy through remittances and their direct contacts with the country tend to create a cosmopolitan atmosphere not found to the same extent in other Arab countries. Unlike other Arab countries, Lebanon is highly urbanized, has almost no arid wasteland, and nomadic groups are virtually non-existant.

From an economic stand-point Lebanon, unlike many of its Arab neighbours, possesses no oil, although it is the terminus for two major pipelines.[3]

The development of the Lebanese economy has traditionally been determined by the development of the trading sector. The geographical location of Lebanon, at the eastern end of the Mediterranean between the consumer

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3. The Aramco pipeline, which runs through Saudi-Arabia from Dhahran to Sidon and the Iraqi Petroleum Company (IPC) line from Kirkuk to Tripoli.

markets of Europe and the raw material sources of the Middle East and India, has meant that a considerable "entrepot" trade has developed.

Considerable impetus to Lebanese economic development was given by World War II when Allied spending in Lebanon substantially increased foreign currency reserves. When the state of Israel was created in 1948, Lebanon became the natural Mediterranean outlet for the Arab world. For instance the Iraqi Petroleum Company pipeline to its original western terminal at Haifa ceased to be used after 1948 and, instead, the outlet switched to Tripoli. These factors, among others, led to rapid development in the Lebanese economy.

Another striking feature of Lebanese economic development has been the lack of government intervention in the economy. A typical remark in this respect is the one made by the F.A.O. in 1959 when they said,

> "The Lebanese economy is as close to a classical laissez-faire model as one can expect in the modern world".[4]

This analysis of the Lebanese economy begins with a detailed discussion of the national income data that are available and the sectoral breakdown of this data. Secondly

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4. F.A.O. Mediterranean Development Project, Lebanon, Country Report (Rome 1959) Chap. I, p.6.

an attempt is made to assess the importance of the trade sector to general economic development.

National Income

Until recently the Lebanese government presented no systematic accounts of national income. The researcher in Lebanon has had to rely on ad hoc estimates of national income, which tend to be very incomplete in themselves. One of the first attempts at estimating Lebanon's national income was done by Badre in 1956.[5] Ultimately this series was extended to cover a period from 1950 to 1958. At the same time the American Embassy issued a series running from 1954 to 1957 and 1959 to 1962. It is interesting to compare the results and the methods employed in these two series. The two series differed both in the absolute level of national income and the rates of growth of income predicted. For instance, Badre's figures gave a compounded real growth rate of national income of just over 6% from 1954-1957, whereas the American Embassy figures gave a growth rate of 14%! Over the longer period estimated by Badre the growth rate dropped to 5.5% and the American Embassy figures gave a rate, for the same period, of 4.1%. It is quite clear that some adjustment in the Embassy figures took place in 1959, and, therefore, the overall growth rate is probably

5. A.Y. Badre, "The National Income of Lebanon", Middle East Economic Papers, (Beirut: Economic Research Unit, American University of Beirut) 1956.

meaningless. As the Embassy figures were prepared and circulated on a private basis it has not been possible to explore these inconsistencies any further.

Badre's estimates were based on estimating the net product value at factor cost of the economy, which was divided into ten sectors. Badre admitted that the value added approach was not easy to apply in the service sectors and, therefore, a 'distributive shares approach' (to use his own words) was used. This means that both output and income methods of estimating national income were combined to derive the results. In essence these methodological problems are a reflection of the tremendous lack of statistics, both at that time and now. The researcher, to a certain extent, has to choose his methods of analysis to suit the data available.

The Department of Statistics in the Ministry of Planning prepared a new assessment in 1964. There was at that time an attempt to draw together the existing series available including a series of estimates drawn up by the Ministry of Finance itself.[6] Since 1964 the Bureau of Statistics in the Ministry of Planning has been responsible for the production of national income data on an annual basis. The most recent figures and the previous series are summarized in Table 4.1. Perhaps the most striking feature of the

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6. Ministry of Finance, Expose des Motifs de la Loi de Finances pour l'Exercise 1966, (Beirut: Presses de la Direction Centrale de Statistiques au Ministere du Plan).

Table 4.1. National Income Estimates: 1950-1973
(in millions Lebanese pounds)

	A. Badre	American Embassy	Ministry of Finance	Ministry of Planning
1950	1,042			
1951	1,086			
1952	1,115			
1953	1,168			
1954	1,256	1,197		
1955	1,375	1,338		
1956	1,417	1,622		
1957	1,503	1,797		
1958	1,325			
1959		1,490		
1960		1,562		
1961		1,610	1,789	
1962		1,650	1,868	
1963			1,951	
1964			2,038	2,861
1965				3,154
1966				3,460
1967				3,442
1968				3,861
1969				4,170
1970				4,463
1971				4,991
1972				5,405
1973				5,724

Sources: A. Badre, op. cit., 1950-1958.
Ministry of Finance, op. cit., 1961-1964.
Ministry of Planning, Les Comptes Economiques
American Embassy, privately circulated data.
Arab Economist, March 1974.

Notes: a) Badre's estimates are at 1954 prices.
b) Both sets of ministry figures are at current prices.
c) The figures for 1969-1973 are estimated from data of G.D.P. rather than national income direct. Thus the National Income figures are G.D.P. - net property from abroad - capital consumption.
d) The 1973 figure is an estimate.

various estimates is the substantially higher figure put forward by the Ministry of Planning. One possible explanation of this is that the Ministry of Planning probably has more complete information in terms of estimating sectoral output and in terms of coverage, than those who tried to estimate national income previously. One interesting feature of the Ministry of Planning figures is that use is made of the value-added approach suggested by Badre in his initial work. Badre's estimates were at 1954 prices. The figures provided by the Ministry of Finance and the Ministry of Planning are at current prices. There is no clear indication of the price base used by the American Embassy; but the disparities with Badre's early estimates suggest that these estimates, too, were at current prices.

The inconsistencies in the data noted in Table 4.1. and the short period covered by the figures do not allow for a rigorous analysis of the information. Even a calculation of per capita income is extremely difficult to perform, since the only official census in Lebanon took place in 1932. Attempts to update this census have been thwarted by the fear that such a census would highlight an actual discrepancy in the alleged ratio between Muslims and Christians, which is the most predominant factor in the structure of power in Lebanese politics. Consequently the present population figures are based partly on extrapolations of the 1932 census and revised estimates based on a

partial sampling exercise, conducted through the official registers of births and deaths. On this basis the government estimate of population in 1950 was 1.28 million, giving a per capita income of LL800 or approximately $250. The 1968 population estimate put the total population at 2.4 million. This gave a per capita income in 1968 of LL1,608 or approximately $510. The estimate for 1973 was 2.6 million which gives a per capita income level of LL2,201 or $846.[7] The general cost of living has been estimated to have risen by about 33% from 1950 to 1972.[8] The validity of this index will be discussed later; but, assuming that it is broadly correct, this means that real growth in national income has been at the rate of 7.5% per annum since 1950. In per capita terms the rate has been approximately 5.0%.[9] On the surface these figures are impressive as they suggest Lebanon has been experiencing fairly rapid growth for the last twenty years and also compares very

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7. The conversion of these per capita figures into U.S. dollars is based on the average monthly exchange rate for the year in question. The national income estimate of LL5,724 million used for the 1973 figure is as yet unofficial.

8. Badre's estimates of national income include a discussion of trends in retail prices from 1950 to 1958. Since then data has been available relating to a general retail price index through the Bureau of Statistics. The index has 1966 = 100, and December 1972 = 114.8. (Bulletin Statistique Mensuel).

9. Estimates presented by the UNCTAD Secretariat to the UNCTAD Conference in Chile in 1972 suggested the annual rate of growth of G.D.P. between 1960 and 1965 was 4.4% and between 1965 and 1970 2.6%.

favourably with the rapid growth rates registered by many African and Asian countries in the 1960's. One qualification that can be made here is that more extensive statistical coverage later in the period under study has meant that national income estimates have probably become more accurate, which means the earlier figures could easily be underestimated. If this is true then the statistical growth rates achieved are greater than the "true" rates by the degree of initial under-estimation.

Although it is extremely difficult to place too much reliance on the national income data that is available, the data is very useful in giving some broad ideas of the contributions of various sectors to national income. The available statistics show that the major contribution to national income comes from the service sector, which accounted for more than 62% of gross domestic product in 1972. A clearer breakdown is given in Table 4.2. The service sector is defined to include transport and communications, commerce and trade, finance, rent and lodging and other services. For comparison the figures Badre computed for 1950 are given.

Table 4.3 also indicates the broad structural changes in the sources of G.D.P. that have taken place since 1968.

The most striking change since 1950 has been the decline in the contribution of the agricultural sector and the relative stagnation of the industrial sector. At the

Table 4.2: Gross Domestic Product 1964-1972: by sectors (in millions Lebanese pounds).

Sector	1950	1964	1965	1966	1967	1968	1969	1970	1971	1972
Agriculture, Fishing, Livestock	206	381	409	442	426	436	431	445	466	587
Industry and Craft	137	411	462	512	493	552	609	661	750	812
Hydro-Electric Output	--	69	78	87	93	98	104	113	118	129
Construction	41	178	200	231	195	193	216	219	239	253
Transport and Communications	36	258	291	309	329	379	383	401	438	470
Rent and Lodgings	96	250	269	284	300	335	385	430	476	523
Finance (Banks and Insurance)	47	108	124	141	149	164	146	165	181	206
Commerce and Trade	285	1028	1085	1183	1160	1359	1435	1527	1726	1886
Government Services	71	245	284	319	337	396	393	424	451	493
Other Services	100	271	320	357	337	357	460	482	557	517
Total	1022	3200	3523	3866	3820	4273	4567	4865	5399	5876

Source: Ministry of Planning, Central Bureau of Statistics, Les Comptes Economiques de l'annee 1971 and Arab Economist, March 1974.

Notes:
a) There was no category for Hydro-electric output in 1950.
b) All figures have been founded to the nearest million, thus column totals may not correspond with the summation of individual entries.
c) All figures are in current prices.
d) The figures for 1972 are estimates only.

Table 4.3: Sectoral contributions (in percentages) to GDP 1968-1972

Sector	1968	1969	1970	1971	1972*
Agriculture, Fishing, Livestock	10.2	9.5	9.2	8.6	9.9
Industry and Craft	12.9	13.4	13.6	13.9	14.0
Hydro-Electric Output	2.3	2.3	2.3	2.2	2.2
Construction	4.5	4.7	4.5	4.4	4.3
Transport & Communications	8.9	8.4	8.2	8.1	8.0
Rent and Lodgings	7.8	8.4	8.8	8.8	8.9
Finance	3.9	3.2	3.4	3.3	3.4
Commerce and Trade	31.8	31.4	31.4	31.9	32.1
Government Services	8.4	8.6	8.7	8.5	8.4
Other Services	9.3	10.1	9.9	10.3	8.8
	100.0	100.0	100.0	100.0	100.0

Source: Directorate of Statistics, Beirut.

* Estimates only.

present time the agricultural sector contributes approximately 9% to national output and yet almost 50% of the total population are dependent on incomes generated by agricultural output. Although their respective volumes of output have risen in recent years, the agricultural and industrial sectors have failed to keep pace with the country's rate of economic growth. Taking the earliest estimates of national income agriculture contributed 20% to G.D.P. in 1950; 18% in 1955; 15% in 1960; 12% in 1968 and 8.6% in 1971, although it appears to have risen slightly in 1972 (as this is a provisional figure, it may be an over-estimate).

Industrial output has not declined quite so severaly. In 1950 industrial output contributed 14% to G.D.P. The figure was down to 13% in 1955, 12% in 1960 and up again to 13% in 1968 and up again to 14% by 1972. Although the figures for the agricultural and industrial sectors are not entirely reliable, they do give a general picture of the Lebanese economy as being a predominantly service one. Within the service sector as a whole commerce and trade are by far the most important elements. In fact a great deal of industrial production is dependent on imports which makes trade doubly important.

One final point to be made before leaving this analysis of national income data concerns the distribution of income. Inevitably one is up against a sparcity of

statistics. The only estimates available date back to those in 1952 prepared by the American University of Beirut. Needless to say, significant changes in the economic, social and demographic composition of the country have made these estimates even less reliable. In the circumstances it seems a rather fruitless exercise to reproduce the 1952 estimates.

However, it is possible to interpret the national income data a bit more closely for evidence of the distribution of income. If we assume that the 72% of national output generated by the tertiary sector in 1971 is largely attributable to the 300,000 workers officially employed in this sector, i.e., there are no major leakages of income through foreign ownership or through ownership by individuals in other sectors, then some LL3,300 million is attributable to the people employed in this sector - giving a per capita output in excess of LL11,000 per year. On the other hand per capita output in agriculture, in terms of those officially recognized as being employed in agriculture, amounts to just over LL3,000. If account is then taken of the very large casual labour force in this sector, then per capita output falls very significantly and in terms of the total population to be supported by this output, per capita output falls to about LL310. This is very much in line with two World Bank estimates in 1967 and 1969 where estimates of average

agricultural wages were put at about LL350.[10]

A Sectoral Analysis of National Income

Having looked at the main trends in national income over the last twenty years it is now necessary to look in more detail at the sectors that contribute to this national income. In this analysis emphasis will be placed on the growth characteristics of each sector and the relationship of the sector to the economy as a whole. In this way it is hoped that some attention can be focussed, particularly on the financial institutions and activities within the sector. It will be shown that the types of finance available to the industrial and agricultural sectors have seriously inhibited their growth. It will be demonstrated among other things that the present financial system in Lebanon has real growth inhibiting features in it. This is why it is important at this stage to identify the various financial sources available to each sector.

Before discussing each sector in detail, a few preliminary remarks of a general nature are essential. (in this analysis the sectors outlined in Table 4.2 have been aggregated into four: agriculture, industry, services and trade). The Lebanese economy has evolved in such a

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10. Similar calculations are made by R.A. Mallet in Seventy Years of Money Muddling in Lebanon, (Beirut: Aleph Press 1973).

way that well over two thirds of the total output of the nation comes from the service sector. We normally associate such a situation with a highly developed economy rather than one in the earlier stages of development. The preponderance of the service sector in Lebanon is the result of a combination of factors. The geographical position of Lebanon has always meant that there has been a great reliance on trade; and in addition it has developed services providing for the neighbouring Arab countries. Agriculture and Industry have developed within the natural restraints set by the country itself; climate, natural resources and natural communication links. This has necessarily imposed a limit on development as Lebanon is a small country with few natural resources, poor communication links from north to south and east to west and a climate which has necessitated a great deal of irrigation. Whilst it could be argued that development in Lebanon simply reflects the principle of comparative advantage, it has at the same time created an imbalance, with a considerable reliance on overseas trade at the expense of domestic industrial and agricultural output. In addition the agricultural and industrial sectors have not received the support of the government in the way that the service sector has. The fact that Syria and Lebanon formed a customs union prior to March 1950 has obviously had some influence on the development of separate infrastructures; but even after 1950

the role of the Lebanese government in development has been minimal. Government expenditure has, for the most part, been concentrated on the development of airports, ports, telephone services and road services rather than, for instance, irrigation projects. In addition government policies of providing no tarrif protection for home produced goods and having a completely free exchange rate have tended to stifle the development of the industrial sector. The attitude of the Lebanese government to economic development is a very important one in that there has been a tendency for the government, until recently, to remain aloof from the economy.

The relationship of the Lebanese government to the economy is a difficult one to describe yet it is a very important element in the economic development of the country. It is perhaps best summarized in a report by the IRFED mission to Lebanon in 1963.[11]

> "Les opérations qui s'y réalisent, si elles, ne peuvent être ni analysees ni comptabilisées, car leur caractère principal est d'être secrètes, sout nombreuses et porteuses de richesse, d'une richesse toujours renouvelée puisqu'elles doivent réusir en quelques heures, quelques semaines ou quelques mois, le long terme et le moyen terme semblant ici sans intérêt".

Direct participation in economic activity by the government is relatively minor. Public sector expenditure in 1972

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11. Institut de Formation en Vue de Development, Le Liban Face a son Development (Etude IRFED), (Beirut: Imprimerie Catholique, 1963).

amounted to 8.6% of total gross national expenditure. The figures for 1965 to 1970 indicate that this share in economic activity has remained almost constant (1965: 9.9%; 1966: 9.8% 1967: 10.5%; 1968: 10.1%; 1969: 10.5% 1970: 10.1%). This general aloofness to economic activity is slowly changing. A series of development plans culminating in the most recent Six Year Plan (1972-1977) intend to increase rapidly the total volume of public spending. For instance the new plan expects total public investment to reach LL1,740 million by 1977. This is an annual average of LL300 million, which is to be compared with a level of public investment of LL120 million in 1971, which, in itself was a drop of 30.6% over the 1970 total. These figures would suggest that planning intentions may not be realized in ther period in question. A more detailed discussion of this Plan is provided later in this chapter.

The present situation is such that government influence on agricultural and industrial development, both diectly and indirectly is minimal. This type of philosophy has meant that agriculture and industry in particular, have developed within the natural restraints set by their respective environments and have not, until recently, been the subject of much government assistance. With this overriding view in mind the individual sectors can now be examined in more detail.

The Agricultural Sector

The contribution of the agricultural sector to total national output has steadily declined till in 1972 it accounted for 9.9% of G.D.P. However the total volume of people employed in agriculture has not varied; such that nearly 20% of the total working population are employed in the sector, and over 50% of the total population are dependent on agricultural output. Herein lies the fundamental problem of this sector. It is highly labour intensive and in terms of output is the least efficient of the four major sectors. This inefficiency arises from a number of separate issues. The first is the system of land tenure and the extent of cultivation in the country. Out of a total land area of 1,017,000 hectares it has been estimated that 530,000 hectares are cultivable.[12] In 1965 the actual area cultivated was 260,000 hectares, representing 49.1% of the possible total. This gave, in 1965, 0.13 hectares per capita, which could rise to 0.266 hectares if all cultivable land was utilized. Bearing in mind that nutrition experts in Lebanon estimate that 0.5 hectares per head is necessary to provide an adequate food supply for the nation, then the need for expanding food production becomes very important indeed, if Lebanon wishes to reduce its dependence

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12. M. Iskandar, (ed.) The Green Plan: A General Evaluation of Performance, (Middle East Economic Consultants 1972) p.9.

on imported foodstuffs. Estimates put forward by the F.A.O. suggest that one agricultural worker and his family can be supported by either 1 hectare of irrigated land or 5 hectares of non-irrigated land. In Lebanon, in 1970, there were 50,000 hectares of irrigated land and 210,000 hectares of non-irrigated land. On the F.A.O. criterion this land can support 92,000 agricultural earners. The official total in 1972 was, in fact, 115,000, indicating that some 23,000 workers were theoretically unemployed, with the possibility of perhaps 50,000 families receiving an inadequate return from agriculture.

Of the total cultivated area, some 82% is owned by those farming it. However, this figure gives a false picture of land ownership since 88% of all plots have an average size of only 2.4 hectares and only one-fifth of all farmers own farms of more than 100 hectares. The generally small size of individual plots means that farmers find it difficult to benefit from attempts to mechanize agriculture and irrigate the land. There have been considerable changes in land tenure over the last twenty years. The situation that prevailed in the 1950's where the short tenancy system predominated, with the tenancy often only being agreed by custom giving the tenant no security of tenure, has given way to an increase in direct ownership, but this move has done nothing to consolidate land holdings.[13]

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13. G. Hakim, "Land Tenure Reform", Middle East Economic Papers, Vol. I, p.78, 1964.

Although there has been a shift to individual ownership, there is still evidence of the effects of the old tenure system. Revolts in 1970 on the northern borders of Lebanon by peasant farmers against the "seignoral" demands of the absentee landlords indicates that a feudalistic system still operates in parts of the agricultural sector.[14] Thus the present structure of land ownership is a great disincentive to higher yields (increasing the share to the landlord in the case of tenancies) and also a tremendous obstacle to comprehensive irrigation schemes.

A second major issue in the development of the agricultural sector, and one which will be emphasised in later comments, is the forms and extent of financial assistance available to the sector. Of the numerous schemes operated on a private and a government basis two are worth considering in detail: i) the Green Plan for promoting increased agricultural output, and ii) the Banque de Crédit Agricole, Industrial et Foncier (B.C.A.I.F.), which was designed specifically to meet the medium and long-term financial needs of the agricultural sector.

The Green Plan was established in 1964 as an autonomous authority for agricultural development.[15] The

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14. The Times, November 12th, 1970.

15. Republic of Lebanon, Plan Vert, (Summary Report, University of Durham Middle East Documentation Centre).

overall operation of the Green Plan is supervised by the Ministry of Agriculture and also the Ministry of Finance, which has to approve the budget for the Plan. The total budget for a twenty year period, approved in 1965, was LL70 million (LL30 million to be spent in the first ten years and LL40 million to be spent in the latter ten years).[16] Of the many objectives of the Plan the main ones seemed to be: i) to reclaim neglected and fallow land, ii) the construction of roads and small reservoirs for irrigation, iii) the production and distribution of seedlings, iv) the establishment of a continuing research programme which would ultimately act as a consultancy service to farmers, and v) the expansion of land under afforestation. These particular objectives had a financial counterpart in that the Plan was authorized to make contributions towards specific land reclamation schemes, for instance, and was also authorized to make agricultural machinery available on a pooled and subsidized basis.

Initially farmers participating in the Plan's activities paid between 15% and 20% of the total cost. This contribution was complemented by a loan from the Plan, repayable from the sixth year of the loan, at a rate of interest of 1% per annum. The loan was secured by the mortgaging of the land in favour of the government. This

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16. M. Iskandar, loc. cit., p.15.

system operated in 1965 and 1966; but was altered in 1967 when the mortgage guarantee system was dispensed with. Broadly speaking, under the new regulations farmers can borrow up to LL100,000 and their own contribution at no time exceeds 39% and can fall as low as 18% on a loan of LL2,000. This more flexible system encouraged more farmers to use the Plan facilities, especially those involved in joint-ownership of land, where the earlier mortgage requirement had made land reclamation difficult.

Between 1965 and 1973 some 1,183 villages received assistance from the Plan, many benefitting two or three times. The total number of farmers benefitting from the scheme amounted to 24,145. The total value of loans advanced by 1973 had risen to LL44,960,532, with farmers' contributions amounting to about 28% of the total loans. In particular the loans were concentrated in three main areas, i) land reclamation, ii) reservoir construction, and iii) wall construction.[17]

The Green Plan has had the effect of developing the underlying infrastructure of the agricultural sector. The relative ease with which loans are advanced plus the existence of technical assistance has meant that its services have been rapidly absorbed into the agricultural

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17. Green Plan, Annual Report 1970, (Green Plan Office, Beirut), and Arab Economist, Vol. VI, No. 62, March 1974, p.15.

sector.

The activities and success of the Banque de Crédit Agricole, Industrial et Foncier (B.C.A.I.F.) in financing agricultural development are far more difficult to assess. Basically farmers can finance their activities through personal savings or family ties, through the commercial banks or through B.C.A.I.F. The commercial banks have, traditionally, tended to lend to the agricultural sector on a short-term basis only. The majority of loans tend to be for a maximum of a year and, therefore, farmers tend to use these credits for current production only. Medium and long-term financial plans have to be met through an agency like B.C.A.I.F.. B.C.A.I.F. was established in 1955 with an original participation by the government in 40% of the capital of LL5 million. In addition to this original capital a government-guaranteed loan of LL65 million was secured from the Banque de Syrie et du Liban at a rate of interest of 2% for four years. The working capital of the Bank was expanded in 1960 by a LL15 million loan from the Development Loan Fund at 4½%. Of the total working capital of LL85 million, 40% was provisionally allocated to agriculture, 40% to industrial development and 20% to hotel development. As it does not accept deposits in the normal way from the public, its ability to create credits is dependant on the total finance made available by the government. In addition there has been

a tendency for B.C.A.I.F. to demand collateral security very much in excess of the value of the loan, which has discouraged borrowers.[18] Thus only relatively prosperous landowners can take advantages of the bank's services. These restrictions have meant that the total loans by B.C.A.I.F. to the agricultural sector have never been important in comparison with commercial bank loans. It has been estimated the B.C.A.I.F. only accounts for 16% of all loans to the agricultural sector.[19] For 1972 this would suggest that total loans by B.C.A.I.F. to agriculture probably amounted to about LL9 million, which is at about the same rate as the Green Plan. The total loans of B.C.A.I.F. reported to the World Bank in 1967 for the agricultural sector amounted to LL36.8 million, which is considerably higher than the figure quoted. However, some of the loans in this higher figure include loans to food processing industries, which should strictly be included in the industrial sector. However, it has to be admitted that there is some dispute as to how much B.C.A.I.F. has loaned to the agricultural sector, and the data that is available does not allow for a conclusive answer. B.C.A.I.F. has tended to loan money at a fixed rate of 5.5%, which is much less than commercial bank rates (10-12%) and private

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18. H.H. Smith, (ed), op. cit., p.228.
19. The Arab Economist, May 1973, No. 52, p.10.

moneylenders' rates (as high as 10% per month), which can be an important source of finance in some isolated areas. An interesting study into problems faced by farmers in acquiring credit in Northern Lebanon highlights a number of the points already made.[20] This study investigated three villages and interviewed fourteen farmers and found that of fifteen loans outstanding at the time of the survey, twelve were provided by moneylenders or relatives. B.C.A.I.F. accounted for two loans and a commercial bank for one. Although the rate of interest offered by B.C.A.I.F. was 5.5% and that by moneylenders ranged from 24% to 70%, moneylenders were preferred because of their proximity and because of the minimal collateral required.

This serves to emphasise a number of points made in chapter Three. Fry's analysis of the moneylenders in Afghanistan suggested that administrative ease may predominate over actual loan costs, such that moneylenders being close, geographically, to potential borrowers tend to succeed where formal financial institutions do not.[21]

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20. R. Sadaka, C. Loomis and D. Taylor, "A Study of the Problems of obtaining Credit and Using it Productively on Some Farms in the Northern Bega's" Mimeo Pamphlet No. AES-1, (Faculty of Agricultural Sciences, American University of Beirut) June 1966.

21. M.J. Fry, Kabul and Kandahar Money Bazaars: Their Role in Afghanistan's Foreign Trade, (Kabul: United States Agency for International Development, June 1973.

Thus the spreading of bank branches into rural areas, as suggested by Porter[22] and Lewis[23] may be more important than the total volume of funds available through the banking agency. In this case B.C.A.I.F. is not important because it has no extensive 'branch' system and seems to demand excessive collateral against the loan.

The financial situation in the agricultural sector is aptly summarized in a U.S. government report on Lebanon, as follows:

> "The lack of credit on reasonable terms has been detrimental to the efficiency of farm operations, because it has inhibited land improvement and the use of productivity-enhancing materials such as selected seeds, fertilizers and pesticides".[24]

Some progress has been made with the introduction of the comprehensive services offered by the Green Plan. However the financial facilities available to agriculture are going to depend upon the creation of medium and long-term financial facilities within the financial sector as a whole and the extent to which the government is prepared to participate in this sort of activity. One encouraging aspect of agricultural development is the gradual development of the water resources of the Litani river in the

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22. R.C. Porter, "The Promotion of the 'Banking Habit' and Economic Development", Journal of Development Studies, Vol. 2, No.4, July 1966, pp.346-366.

23. W.A. Lewis, The Theory of Economic Growth, (London: George Allen and Unwin 1963) p.229.

24. H.H. Smith, (ed.), loc cit., p.228.

Southern Bega'a Valley. Two irrigation schemes, one below and one above the Karaoun Dam now have the potential to irrigate over 40,000 hectares of land. Two constraints on this development have been the topography of the land and the very fragmented land ownership system. Little can be done about the first point, but as regards the second point an effective policy of land consolidation may lead to a more efficient distribution of water. It is interesting to note in this context that over 15% of public investment under the Six Year Plan is allocated to agricultural and irrigation projects.

The Industrial Sector

In 1964 manufacturing industry contributed 13% of national output. Since then its contribution has fluctuated between 12 - 14%. If the construction sector is included in the industrial sector then the total contribution rises to over 17%. At the same time the industrial sector employs about 15% of the total work force. Industrial exports contribute approximately 18% to total exports and account for 12% of total output in the sector. Of 6,500 industrial enterprises registered in 1971, 2,600 employed less than four persons and only 140 more than forty persons. On average there are less than 12 workers per firm and the capital employed per worker is less than

LL1,000.[25] The main exceptions to this situation are two oil refineries, two cement factories and new LL100 million fertilizer plant. It is planned to add a third oil refinery and other large scale factories for the production of paper, cement, newsprint and televisions. Nevertheless, the predominant feature of Lebanese industry is the small size of individual enterprises and the low level of capital utilization per head. In this respect Lebanon compares somewhat unfavourably with some of her Middle Eastern neighbours. For instance workers per establishment are as high as 23 in Egypt and 59 in Iraq.[26]

The 1964 industrial census is the most recent survey of industrial activity in Lebanon. This census highlights the points made already about the average size of establishments and the average capitalization per worker. In addition, as might be expected, the contribution of large firms to total output is disproportionately large. 51.4% of all establishments (out of a total of 2,099) employ less than nine people and, in total, account for only 8.8% of all sales. On the other hand 5% of total establishments employ over fifty people and account for 59% of all sales.

Of total sales of LL550 million in 1964, the food

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25. "The Industrial situation in Lebanon", in State of Kuwait, Ministry of Foreign Affairs, Conference on Industrial Development in the Arab Countries, March 1966, Vol. 2, pp.63-64.

26. "The Industrial Situation in Lebanon", op. cit., p.64.

processing industries accounted for LL165 million. If the contributions of oil refining (LL76 million); textiles (LL36 million) and cement and construction materials (LL44 million) are added to this then it can be seen that these four industrial sectors account for nearly 60% of all industrial sales. In addition to this concentration over 68% of all establishments are located in the Beirut area. Total registered employment in the industrial sector rose from 44,984 in 1964 to an estimated 95,500 by 1970, and was probably in excess of 100,000 by 1974. This total does not include the large number of itinerant workers from Syria, who often work in smaller industrial establishments.

Two important stimuli to industrial development must be infrastructure developments and increasing investment. As regards infrastructure developments, the guarantee of constant electricity is an important factor, since many larger factories at the moment rely on their own generators rather than the uncertain public supply. Improvement in electricity supplies is going to depend to a certain extent on the improvement of hydro-electric facilities in the Bega's Valley. By 1971 over 52% of all electricity generated came from hydro-electric sources.

The majority of Lebanese industry is privately-owned; the State tobacco monopoly being the only major exception. Some industries, e.g. beer, cement, fertilizers, are partly owned by foreign companies. In general, however, investment

has to be in terms of small-scale indigenous enterprises. Given the small size of industrial units and this ownership pattern, one of the principle sources of industrial finance is internal finance. There does not seem to be any significant dependence on external medium-term and long-term finance. The principle sources of external industrial finance are B.C.A.I.F. and the commercial banks.[27] The commercial banks as a whole granted credits to the industrial sector in 1968 to the extent of LL368 million; but this only represented about 12% of total commercial bank advances in that year. By 1971 total credits granted had risen to LL435 million (16.6% of total advances in that year) and by 1973 to LL760.2 million (20% of total advances). If credits granted to construction are included then nearly 30% of all advances go to industrial activities.[28]

The contribution that B.C.A.I.F. has made is much more difficult to assess. Average lending to industry by B.C.A.I.F. in recent years has been estimated to be of the order to LL5 million per year, which is insignificant in comparison with commercial bank lending.[29]

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27. Raising money through a share issue is difficult, especially for new firms, since new enterprises wishing to raise capital through a share issue are restrained by a Lebanese Law which requires the company to publish balance sheets for two years before the issue.

28. More details of the sectoral distribution of loans is given in Chapter Seven.

29. Privately secured information. The contribution of B.C.A.I.F. only represents 1½% of the loans granted by commercial banks.

Commercial bank lending to the industrial sector has been rising slightly between 1966 and 1973. In 1966 12% of all advances went to industry. By the beginning of 1973 this had risen to nearly 20%. There was an absolute drop in lending from 1968 to 1969; but the general upward trend is encouraging in that what limited industrial development that has occurred does not seem to have been adversely affected by existing credit arrangements. However this is only a short-term expansion and there is no guarantee that a more rapid advance in industrial activity will be accommodated by the financial sector. The Six-Year Plan (1972-1977) envisages an expansion of 9% - 10% per annum in industrial investments. To achieve this there must be either considerable government participation in this investment or the commercial banking sector must meet this demand for medium-term and long-term finance or else they will not be involved in this sort of development. As Hoss states,

> " . . ., Lebanon's future growth is likely to place a greater accent on industry than has been the case in the past. Hence, if the banks are confined too strictly to the short-term end of the market, their role in the country's future development will be impaired."[30]

Evidence in support of this statement is provided by the fact that total deposits with the commercial banks rose

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30. S. Hoss, "The Banking System since 1966", The Banker, November 1972, p.71.

by 54% between 1966 and 1970 but total domestic bank credit only rose by 10%.[31] Thus the banks, by confining themselves to short-term lending are unable to fully utilize their resources in the rather narrow internal market. The very rapid increases in the commercial banks foreign assets during the same period does indicate where the surplus went to. The Lebanese Government is now considering amending the Money and Credit Act to allow the central bank to grant credits to banks against medium-term industrial paper in cases of need. This type of development may encourage more active participation by the commercial banks in industrial financing. At the moment the commercial banks are not willing nor are they suitably equipped to meet any rapid industrialization programme.

The extent to which rapid industrialization can occur is dependent not only on financial conditions but also on the structure of the industrial sector itself. It has already been mentioned that the industrial sector consists predominantly of small family businesses. Such a structure cannot benefit from the obvious economies of scale associated with many industrial products. This means that Lebanese industrial products often cannot compete successfully with imported goods thus stifling any growth potential

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31. S. Hoss, op. cit., p.71

in the sector. It has been further suggested that some industries established in Lebanon to provide not only for domestic markets, but other Arab markets have been stifled by restrictive tariff systems adopted by some Arab countries.[32]

Government legislation has recently attempted to assist this process of industrialization by proposing the establishment of a Ministry of Industry. Other legislation has granted tax exemptions to certain new industries whose products were not manufactured in Lebanon prior to 1971. Unfortunately the tax exemptions only apply if the annual salary bill is in excess of LL200,000, which is clearly well above the sort of wage bill a small family establishment would be faced with. This type of legislation is probably well intentioned but seriously misses the mark.

A more serious threat to industrialization plans in the near future is the considerable commercial lobby both in parliament and within the financial sector which believes that industry and commerce are by nature rivals. The very considerable criticism of the proposed Ministry of Industry by commercial lobbies seem to underline this point.[33]

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32. R.A. Mallat, op. cit., p.31.
33. The Arab Economist, No. 52, May 1973, p.20.

Development in the industrial sector is generally restrained by the lack of capital on the financial side and a dearth of raw materials and skilled labour on the real resource side. So far the government has paid very little part in promoting industrial development. In fact the liberal trade policies pursued by the government have, by and large, restrained the development of the industrial sector, as the government has not been willing to extend protection to new industries by raising tarrifs on certain imports.

In conclusion the industrial sector needs to expand its own output at least as rapidly as the overall growth of the economy. If its growth is slower this means that an increasing volume of imports of manufactured goods will be necessary to maintain consumption at a level consistent with the overall growth of the economy. To compound this problem a stagnant industrial sector means that the export of manufactured goods is not able to rise to meet the ever-increasing demand for imports. This can lead to structural weaknesses in the balance of payments, which will be discussed later.

One of the factors which could contribute to industrial expansion is the provision of a viable medium-term and long-term financial market. The existing arrangements are totally inadequate in terms of the requirements of industry and in the long run the lack of these provisions may retard

the general growth of the economy.

One positive move to fill in this gap in the provision of medium- and long-term finance has been the establishment of the Development Bank for Tourism and Industry; established in 1973 with a capital of LL60 million and a 51% government participation. In its first year of operations over LL10 million has been advanced (75% to tourism and 25% to industry).

Of course it could be argued that it is not financial provision which is inadequate, but rather a lack of feasible and well-prepared investment projects requiring financial support. Even if this is the case, it could be argued that the banking system could take the initiative and provide investment project consultancy services to industrial customers: there seems to be no signs of such "innovative finance" at present.

The Service Sector

Tourism and banking make the most significant contributions to national output within the service sector. Both activities are important for other reasons as well. Tourism is a major source of foreign exchange earnings and banking is important in terms of the financial services provided to other sectors in the economy; a service not

fully accounted for in the national output framework, as was pointed out in chapter One.[34]

The total number of overseas visitors to Lebanon in 1973 was approximately 1,000,000 (that is excluding about 1,200,000 Syrian arrivals which, in some cases, may be tourists but are normally classed as itinerant workers).[35] The figure for 1972 was the highest for the 1950-1973 period Apart from a severe drop in numbers in 1967 (largely due to the Israeli-Arab war), there has been a steady increase in numbers since 1960. However, from 1960 to 1966 the average annual growth in tourist numbers was 20%, but since 1968 this growth rate has dropped to about 10%. Although total tourist numbers have risen again since 1967, the composition of these numbers has changed. For instance the total number of American Tourists to Lebanon dropped from 93,000 in 1966 to 67,000 in 1969, although it has now risen again to 94,000 in 1973. A similar trend applies to European tourists. Traditionally American and European tourists, although small in numbers, have been the biggest spenders and consequently tourist receipts do not appear to have expanded as rapidly as tourist numbers.

The rapid expansion in tourist numbers recorded in the early part of the 1960's meant that a considerable construction boom was stimulated, especially in the

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34. See page 5.

35. Bulletin Statistique Mensuel, December 1973.

building of new hotels but also in entertainment facilities in general. The total number of starred hotels in Beirut rose from 51 in 1961 to 80 in 1968 and in the mountain area behind Beirut the number of starred hotels rose from 181 in 1961 to 209 in 1968. The boom in hotel building was part of a general construction boom which hit a peak in 1966. Table 4.4 gives one indicator of this boom, i.e. the number of construction permits issued in Beirut from 1960-70. The issuing of a permit does not indicate that building will take place. It merely represents a desire to build. In this sense Table 4.4 represents a sort of ex ante demand for construction facilities. It does not indicate the actual construction that took place. However it is useful in indicating the broad trend throughout the period.

It is clear that the rapid growth in tourist numbers up to 1966 created a lagged response in the construction industry, with construction hitting a peak in 1966 when the Intra bank failed and, later the Arab-Israeli war in 1967, significantly reduced tourist numbers. For this reason in particular tourism has become an important but volatile element in national output.

There are two aspects of this construction boom that are interesting. The first is that a very high proportion of all building permits are for hotels, office accommodation and flats. This means that the general level of

Table 4.4: Construction Permits Issued in Beirut 1960-1970

Year	No. of permits	Area (in square metres)
1960	1,226	704,200
1961	982	664,850
1962	869	572,200
1963	1,071	797,380
1964	1,088	732,250
1965	1,181	1,016,750
1966	1,192	1,243,000
1967	651	714,000
1968	647	674,000
1969	623	630,000
1970	523	580,000

Source: Recueil de Statistiques Libanaises, Ministere du Plan, Direction Central de la Statistique, 1970.

prosperity and the growth of tourism is very important. Secondly, a great deal of financial assistance for construction comes from the banking sector. Many commercial banks in Lebanon have become involved in financing hotel and office development. This type of financing is normally not a major element in the portfolio of a British bank; but in Lebanon commercial banks have been involved in this type of long-term finance to a considerable extent. In recent years something like 10% of all commercial bank

loans have gone to the construction industry. These loans are usually highly illiquid in that they are not redeemable till the building is complete and with the cut back in construction since 1966 this situation has become something of an embarrassment to some local banks. It is primarily the indigenous commercial banks that are involved in this type of finance. The expatriate banks have not involved themselves and hence have been less affected by fluctuations in the tourist and construction industries.

The long-term prospects for tourism are uncertain. The experiences of 1967 and the open hostilities between the Lebanese government and the Palestinian refugees in 1972 and 1973 suggest that when there is open conflict in the Middle East then tourist numbers do decline. Therefore the extent to which the Arab-Israeli conflict and ancillary conflicts involving Palestinian refugees are live or dormant will determine to a large extent the viability and growth of the tourist sector.

A report on the Tourist Industry prepared in 1963 stated that,

> ". . . Lebanon has natural tourism assets and other advantages which offer rich prospects of tourism becoming its major single industry and the largest and most stable contributor to its balance of payments . . ."[36]

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36. Transport and Tourism Technicians Ltd., Survey of Lebanon's Tourist Industry: Part I, Recommended Development Programme, 2nd edition, May 1963, p.A-3.

Ten years later this view still is of considerable importance in planning tourist facilities, although it has to be recognized that political and social events have thwarted any systematic development of the tourist industry over the last decade.

There are indications that the banking and insurance sector is not as heavily influenced by this type of external factor. Banking and insurance services contribute about 5% to national output; but these services have a more fundamental importance than is indicated by this percentage. It is estimated that banking and insurance facilities are sufficiently well developed to encourage both net capital inflows (estimated at approximately $100m. at the present time)[37] and net earnings on banking and insurance services. Therefore, the real benefits of banking and insurance facilities may show up more clearly in the balance of payments' accounts than the national income accounts.

Where banking and insurance facilities are important is in providing the most efficient (from a cost and distribution point of view) financial system consistent with a given growth in real output. In this context the ability of the financial sector to finance agricultural and industrial development is of paramount importance. This financial aspect of development is very important

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37. Privately secured information.

and indications have already been given of the financial needs of the agricultural and industrial sectors.

The Trade Sector

This sectoral analysis of the components of national income concludes by looking at the trade sector. The most significant element in the Lebanese balance of payments is the very large and growing deficit on visible trade. This is shown in Table 4.5.

Such a deficit is not surprising. Only 25% of total output is generated by the industrial and agricultural sectors and therefore the economy has to rely heavily on imports of industrial and agricultural goods.

A summary of the balance of payments for 1960-1969 is contained in Table 4.6. In addition, in Table 4.7, a different presentation is given for the years 1969-1973. These two presentations are a perfect example of the problems involved in standardising data in Lebanon. Table 4.6 presents the official accounts, compiled by the Ministry of Planning. An official presentation of the balance of payments was first achieved in 1966 and the figures prior to 1966 are based on estimates prepared by the American University in Beirut. The visible trade data in Table 4.6 do not correspond directly with the

Table 4.5 Import and Export of Goods, 1960-1973*
(in millions of Lebanese pounds)

	Imports	Exports	Deficit
1960	1,098	137	961
1961	1,271	155	1,116
1962	1,359	181	1,178
1963	1,310	185	1,125
1964	1,565	199	1,366
1965	1,668	269	1,399
1966	1,925	323	1,602
1967	1,770	453	1,317
1968	1,865	504	1,361
1969	2,214	606	1,608
1970	2,232	643	1,589
1971	2,447	807	1,640
1972	2,819	1,168	1,651
1973	3,300	1,300	2,000**

* Including some transit items and re-exports.

** Provisional figures.

Sources: Banque du Liban, Rapport sur l'Exercise, 1967, Ministere du Plan, Bulletin Statistique Mensuel, and Arab Economist, March 1974.

Table 4.6: Summary of the Balance of Payments 1960-1969. (in millions Lebanese pounds)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969
Visible trade (net)	-675	-812	-683	-755	-897	-1062	-1153	-922	-1065	-1034
Non-monetary gold	-7	-7	-6	-7	-7	-7	-11	-9	-11	-10
Tourism	29	84	76	89	137	176	189	122	220	236
Transport	145	114	158	141	162	179	156	154	172	175
Interest & dividents	78	71	74	80	80	78	97	124	130	138
Government expenditure	67	71	77	84	91	93	100	102	124	125
Other services	164	168	170	181	181	192	212	219	244	234
Goods & services (balance)	-199	-310	-133	-187	-252	-352	-411	-209	-184	-136
Donations & transfers	105	111	89	95	82	78	69	85	82	85
Current A/C balance	-94	-199	-43	-92	-169	-342	-432	-124	-102	-51
Private capital long	51	48	46	40	51	52	45	14	32	36
Private capital short	84	104	67	58	108	147	264	118	261	104
Government capital long	14	18	11	7	20	5	22	16	13	12
Capital A/C balance	149	170	124	106	179	204	321	148	306	152
Total balance	+55	-29	+81	+14	+70	-138	-111	+24	+204	+101
Errors & omissions	-18	+79	+65	-10	+72	+124	+375	-26	-28	-27
Variations in official reserves	37	50	145	4	81	55	122	-1	176	73

Source: The Balance of Payments of Lebanon 1960-1969, Ministry of Planning, Central Bureau of Statistics, Beirut.

Table 4.7: The Balance of Payments 1969-1973 (in millions Lebanese pounds)

	1969	1970	1971	1972	1973
I. Goods and Services					
A. Goods					
Exports	809	943	1149	1551	1776
Imports	1853	2043	2434	2952	3518
Trade Balance	-1043	-1100	-1285	-1401	-1742
B. Services					
Government	125	126	150	154	165
Non-Government	782	844	990	1095	1130
All services	908	970	1140	1249	1295
Goods and services (balance)	-135	-130	-145	-152	-447
II. Gifts and Transfers	85	90	95	105	130
All current account operations	-50	-40	-50	-47	-317
III. Capital Movements (net) (errors and omissions included)	239	524	969	813	534
IV. Monetary Movements (additions -, losses +)	-188	-484	-919	-766	-217
Official Reserves	-52	-112	-543	-317	-117
Private Institutions	-136	-372	-376	-449	-100

Source: Banque du Liban, Rapport sur l'annee, 1973.

presentation in Table 4.5, since some transit items and re-exports are deducted from the figures in Table 4.5 to give the visible trade balance. Since 1969 balance of payments accounts have been published by the Central Bank, ostensibly from data compiled by the Ministry of Planning; but a number of individual items have been aggregated to make direct comparisons almost impossible. Nevertheless, the increasing trade deficit noted in Table 4.5 is also brought out by the figures presented in Table 4.6 and Table 4.7.

The most significant features of Tables 4.6 and 4.7 apart from the visible trade deficit are the rapid expansion in tourist receipts during the decade and the continuing surplus on capital account. The balance of payments accounts also show that Lebanon has, throughout the decade (apart from 1965 and 1966) had an overall surplus on capital and current accounts, combined.[38]

The variations in official reserves do not necessarily correspond with movements in the overall balance. This is largely due to the great difficulty in categorizing a number of capital and invisible trade flows. For instance remittances may be classified as capital inflows if there is no clear indication of the source and potential use

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38. The very large errors and omissions items for 1965 and 1966 probably indicate the difficulties in transferring the estimated data pre-1966 to the official format for 1966 onwards. Thus the recorded overall deficits in these two years should be interpreted with some caution.

of the funds. This will have the tendency to exaggerate any adverse balance on current account. Equally supplies of foreign currency may be increased through short-term capital movements benefitting from the freely-floating foreign exchange market, which are not recorded in the balance of payments accounts. Whatever the true picture is, the Central Bank has accumulated foreign currency reserves during this period, as can be seen from Table 4.8.

Unfortunately, it is impossible to describe accurately the obligations which should be set against these assets. We can assume that bank deposits denominated in foreign currencies are covered by the commercial banks' foreign currency reserves; but we cannot assume the same for foreign deposits denominated in Lebanese pounds. In this case the Central Bank may find its own reserves diminished if there was a substantial withdrawal of these latter deposits. However, it is very likely that foreign deposits denominated in Lebanese pounds probably do not account for more than 5% of total deposits, which would indicate, at the present time, a figure of LL290 million.

Thus Lebanon's external payments position is difficult to assess. It is clear that the trade deficit has been amply covered by invisible earnings and the foreign exchange holdings of the Central Bank; but in the future it is difficult to see whether the level of invisible earnings can be maintained if tourism is influenced by

Table 4.8: Gross foreign assets (millions of Lebanese pounds)

	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973
Gold	594	561	594	604	913	933	933	1106	1057	973
Fund gold tranche position	5	5	5	7	7	7	7	8	8	7
Foreign exchange	153	213	274	269	134	185	312	613	972	1174
Total	752	779	873	880	1054	1125	1252	1727	2037	2154
Commercial banks	1460	1848	1584	1317	1574	1641	2088	2597	3161	3610
Total	2212	2627	2440	2197	2628	2766	3340	4324	5198	5764

Source: International Financial Statistics, Bank of Lebanon, Annual Reports.

external political events such as the Arab-Israeli conflict and whether the banking sector can continue to increase its capacity for earning foreign exchange. In the long-run this type of situation may put considerable pressure on the Lebanese pound, although it has to be conceded that during 1974 the Lebanese pound has benefitted from short-term capital movements into Lebanon, mainly from oil states in the Middle East. Alternatively the imposition of stricter import controls may be required. It is difficult to see what effects these moves would have. There is very little development of import-substitution industries in Lebanon at the present time, therefore any changes in import prices can be expected to have little effect on import demand. Any improvement in export earnings must come from the service sector. There is no indication that Lebanon can develop industries capable to making any impact in the export field and, therefore, the success of the Lebanese economy must rest on increasing earnings from tourism. Ultimately the successful development of the Lebanese economy may rest on a deliberate policy of diversification, encouraging industrial and agricultural activities, thus reducing the economy's dependence on basic imports.

Summary and Conclusions

This sectoral analysis of national income has helped to highlight, in particular, the financial deficiencies within each sector. Within the agricultural and industrial sectors the obvious need is for a substantial increase in medium-term and long-term credits. The marked reluctance of existing commercial banks to enter this field of finance would seem to imply that some form of development bank is probably necessary. In November 1971 the Lebanese Government announced plans for a new Development Bank with a paid-up capital of LL60 million, with a 51% government participation. Development banks have been established before (an industry and trade bank was established in 1969 with little success) and, therefore, their establishment is no indication that they will become operational. However this move by the government does seem to indicate that they recognize that there is a considerable shortage of medium-term and long-term finance, which is necessary for agricultural and industrial development, and that this shortage is not being met in any way by the commercial banks.

The obvious sensitivity of the service sector to political and other events might suggest that a more "balanced" development of the Lebanese economy might be desirable. In this context balanced development would imply an increasing share in national output for the

industrial and agricultural sectors. Khalaf describes the Lebanese economy as "lopsided" in that the distribution of national income is unsymmetrical.[39] Whilst Khalaf goes on to argue that this particular distribution of income is very much in line with resource endownments in Lebanon, it is also reasonable to argue that such a distribution may expose the Lebanese economy unduely to external influences. Khalaf examines a number of such external influences in detail and comes to the following conclusion,

> ". . . concentration in trade, and mainly regional concentration, was found to reduce Lebanon's ability to isolate itself from outside influences and to render the trade sector more vulnerable to policy measures of neighbouring countries, as such to be a possible source of precariousness and instability . . .[40]

He also isolates increasing dependence on services and capital movements as possible sources of instability. This would seem to suggest that developments in the Lebanese economy must be aimed at redistributing national output as between sectors. This means that industrial and agricultural output must grow at a faster rate than service output: something that has not happened over the past twenty-three years!

The Lebanese Six-Year Development Plan 1972-1977 does indicate that a more rapid growth in industry and agriculture

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39. N.G. Khalaf, Economic Implication of the Size of Nations, with Special Reference to Lebanon, (Leiden: E.J. Brill, 1971) p.157.

40. N.G. Khalaf, op. cit., p.234.

will occur in the planning period as compared with service sector growth. Agricultural output is planned to grow at 5% per annum and industrial output at 10% per annum.[41] Service sector growth is planned at 6.7% per annum. Total investment during the planning period will amount to LL7,200 million, of which LL1,740 million will come from the public sector.[42] Thus over 75% of total investment is planned to come from the private sector, although the Plan gives no indication of its sectoral distribution. Although the public sector investment programme is small in terms of total investment it still represents a doubling of investment over the 1964-1969 period. Given the present sectoral distribution of national output, it is difficult to see how the rapid expansion in industrial output can be achieved. Although the Plan sees an adjustment taking place in the sectoral shares in national output, the present predominance of the service sector does not seem likely to be affected during the planning period, since the bulk of investment and consumption is already in the service sector and the Plan gives no clear indication about how any switching of consumption and investment expenditures might occur.

Although the present Six-Year Plan does show that the Lebanese government is aware of the economic problems

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41. This compares with actual growth of 2.5% for agriculture and 7.5% for industry in the 1964-1969 period.

42. In 1969 prices.

facing the nation, the policies adopted in the Plan are probably not strong enough to generate any major shift in economic activity during the planning period.

What is far more serious is that the Plan gives scant attention to the financing aspects of investment. An evaluation of the Plan carried out by the United Nations Economic and Social Office in Beirut (U.N.E.S.O.B.) came to the conclusion that,

> ". . . The treatment of investment financing in the Plan is rather inadequate. Investments by the private sector, by autonomous bodies and by municipalities, which account for 84 per cent of total investment, are accorded no more than two sentences in the plan document . . ."[43]

Thus the Plan intends to rely very heavily on the existing financial sector, without actually stating what that reliance will be or without analysing the behaviour of the financial sector to see whether it is capable of generating new financial instruments at the rate required by the Plan. Ideally a fully developed financial plan is an essential prerequisite to the planning of real resource developments. A sectoral breakdown of investment and savings is necessary in order for the financial planner to ascertain whether consistency exists between these sectoral distributions and the total inputs (savings) and total outputs (investment)

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43. United National Economic and Social Office in Beirut, The Lebanese Six-Year Development Plan 1972-1977: An Evaluation, Occasional Paper No.2, (Beirut: U.N.E.S.O.B. March 1973) p.14.

of the financial system.[44] Even in the absence of sophisticated financial planning of this sort, it is certainly tenable to argue that the achievement of investment targets within the total Plan will be assisted by more detailed knowledge of the ways in which the financial system works. Against this background of recent developments in the Lebanese economy, the next five chapters attempt to provide this more detailed knowledge and will attempt to highlight specific deficiencies within the financial system which may adversely influence the investment programme within the Six-Year Plan.

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44. M.J. Fry, "Financial Analysis and Economic Planning: Applications to the Turkish Economy", (Privately circulated paper).

C H A P T E R F I V E

The Development of the Banking Sector

The arguments developed in Part I and in Chapter Four provide an appropriate background against which to describe the developments, functions and shortcomings of the financial sector and the role of monetary control in the financial sector. This chapter presents a fairly brief history of developments in the banking sector, primarily since 1950, and lays particular emphasis on developments since 1960. This chapter will show that the foreign banks in Lebanon have always had an important part to play in the banking structure - an importance which has tended to increase over time. The description of banking developments is deliberately kept brief. A number of books have been written describing banking developments in Lebanon, notably those by Asfour,[1] Hanna,[2] Himadah,[3] and Yafi,[4] and this chapter does not attempt to repeat, in however a condensed

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1. A. Asfour, Commercial Banking in Lebanon, (Beirut: American University of Beirut 1959).
2. A. Hanna, Banking and the Economic Organization of Lebanon, (Beirut: Dar Al-Founoun Press, 1953).
3. S.B. Himadeh, Monetary and Banking System of Syria, (Beirut: American Press 1935).
4. T. Yafi, The Monetary and Banking System of Lebanon, Ph.D. dissertation, University of Wisconsin 1959, (Ann Arbor; Michigan: University Microfilms Inc.)

form, the developments detailed in these books. What this chapter does attempt to do is to distill many of the points made about early banking developments in Lebanon, so that the salient features only are presented. Where early developments have dictated the present pattern of the banking sector then due emphasis is applied.

> ". . . The growth of the Lebanese banking sector is very recent. Its history goes back over a few decades only. One can, however, trace the existence of banks back to the second half of the nineteenth century. But these were mainly foreign. They financed foreign trade, leaving domestic trade to the few small local banks and discount houses. . ."[5]

This brief statement by Asseily aptly summarises the major points to be developed in this chapter.

Lebanon as a distinct entity was recognized as a state within the Ottoman Empire by the Protocol of September 6th, 1864, which created an independent fiscal regime in the Mount Lebanon area. At this time considerable French capital was being invested in Lebanon, which was further encouraged by the opening of the Suez Canal. A number of companies were formed in this period to develop both port facilities and railway facilities. For instance among the founders of the Turkish Company of the Port Quays and Warehouses of Beirut in 1888 were the Imperial Ottoman

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5. A.E. Asseily, Central Banking in Lebanon, (Beirut: Khayat Publishing Company 1967) p.28.

Bank, Banque du Paris et des Pays-Bas and Comptoir National d'Escompte de Paris.[6] The Imperial Ottoman Bank also developed a number of branch banks in cities such as Tripoli, Saida and Zahle. This bank was recognized by the Turkish Treasury as the state bank and Beirut was the bank's most important foreign (i.e. outside Turkey) branch. Beirut, at that time, was an important trade centre and the principal function of the Imperial Ottoman Bank was to finance trade. However, it also performed another very important function. It was instrumental in negotiating loans on a number of European money markets for a number of projects in Lebanon. For instance a 4% loan was negotiated for the Port of Beirut Company in 1899 and a number of loans (3% in 1894; 4% in 1901; 4% in 1905 and 4% in 1909) were negotiated for the construction of a railway network between Beirut and other major centres such as Damascus, Hauran, Hamah, Aleppo and the creation of a link to the, then, incomplete Istanbul-Baghdad line.

In this period, prior to the first world war, there were in Beirut, in addition to the Imperial Ottoman Bank, the Deutsche Palestina Bank, the Deutsche Orient Bank (both German) and the Banque de Salonique (French).[7] There

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6. Anon, "Foreign Banks in Lebanon - Origins and Growth", The Banker, p.84.

7. S.B. Himadeh, op. cit., p.30.

is very little information of local banking enterprises for this period. As the expatriate banks tended to finance trade and took little part in industrial and agricultural financing it can be assumed that what little industrial and agricultural finance there was was provided by local banks of one sort or another. It has been estimated that 75% of the population were engaged in agriculture at this time and, therefore, when in need of funds, farmers would normally resort to money lenders, situated locally; often paying exorbitant interest rates.[8]

With very little indigenous banking development, Lebanon was placed in a difficult situation at the end of the first world war when the defeat of Germany and Turkey meant the closure and withdrawal of most of the expatriate banks. This left a void which was not easily filled. The beginning of the French mandate at the end of the first world war meant that banking development now relied on French initiative. The Banque de Syrie et du Liban took over the elementary central banking functions formerly vested in the Imperial Ottoman Bank's functions such as sole note issuer. Various other French banks followed this initiative and a few local banks were established, such as Banque G. Trad and Co., Banque Sabbagh and Banque

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8. A.E. Asseily, op. cit., p.28.

Thomé. The pattern of development seemed to be for the local banks to finance domestic trade and for the foreign banks to concentrate on international trade. In addition local banks also began to deal in mortgage finance; an aspect which is still important today.

Because local and expatriate banks pursued these separate functions, it meant that they were able to prosper side by side. Normally the local banks might have been expected to be unable to compete effectively with the expatriate banks; but this was not the case in Lebanon. The local banks were well known to local merchants and they relied on their good name to attract deposits away from the expatriate banks. Judging by the number of banks that survived this early period of development one can conclude that they must have been successful in attracting deposits.

The post-first world war period also brought about a number of changes in Lebanese currency arrangements. The Turkish lira was replaced by the Lebanese-Syrian pound and the responsibility for the issuing of this new currency was vested in the Banque de Syrie et du Liban, at that time a French subsidiary of the Ottoman Bank and the Banque de Paris et des Pays-Bas. The initial rate was set at 20 French francs to the Lebanese-Syrian pound. Security for the issue was provided by a stock of gold and

franc reserves.[9]

A wide variety of banking institutions were established in Lebanon during the period of the French Mandate (1920-1941). Typical of this development were banks such as Crédit Foncier d'Algerie et de Tunisie (1924)[10]; Compaigine Algérienne de Crédit et de Banque (1927)[11]; Banco di Roma (1926); Banque Misr[12] (Egyptian 1929) and the Arab Bank (Jordanian 1943).

Although there was this considerable development of foreign banking enterprises, local banks were still able to prosper.

One particular type of business which distinguished local banks from the expatriate banks was mortgage finance, and the use of land and buildings as collateral for borrowing requirements. In Lebanon land is one of the chief assets held by many people and naturally merchants, in particular, wanted to finance their trade by using their real estate as security for the loan. This type of borrowing procedure was basically alien to the French banks in

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9. More details of these arrangements are provided later in this chapter, when the functions of the Banque de Syrie edn Liban are discussed in more detail.
10. Now called Societe Cantrale de Banque.
11. Now called Banque Franco-Libanaise.
12. Now called Banque Misr-Liban.

Lebanon and thus the local banks were able to develop this type of finance without coming into direct competition with the expatriate banks. In fact the foreign and local banks tended to help rather than hinder each other. The local bankers often found they had an excessive number of potential borrowers and very limited funds to meet the demand. The foreign banks, because of their reluctance to lend to local traders, found they were accumulating funds with few borrowing outlets. In this situation it was natural for a rudimentary inter-bank loan market to develop where the foreign banks became net lenders to the local banks, who then used their increased reserves to satisfy the local demand for loans. The high rates of interest charged by the local banks ensured that they could pay a rate of interest on the inter-bank loan and also make a profit.

By the late 1930's Himadeh has estimated that there were about thirty indigenous financial institutions; fifteen of which would be regarded as banks in that they accepted private deposits and created loans. The remainder functioned more like discount houses.[13]

When the French mandate ended and Lebanon gained independence in 1948, the new government introduced no

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13. S.B. Himadeh, loc. cit., pp.173-174.

legislation to control the operations of the commercial banks. This meant that anyone was free to open a bank and operate it in any way he wished, as long as he abided by the "Code de Commerce". Consequently, there were no regulations concerning minimum reserve ratios, publication of balance sheets, minimum capital requirements. In this laissez faire climate it was not surprising that a large number of banks set up office in Beirut. This is not to suggest that there was a sudden expansion in the demand for loans. Many very small banks were established at this time, of ten based on family funds. In fact it has been suggested that some businessmen who were not considered credit-worthy by the existing banks set up their own banks to satisfy their own financial demands.[14] The fact that no regulations existed to control this type of banking development meant that virtually anyone could move into the banking sector.

Considerable impetus was given to these developments by the net inflow of refugee capital from neighbouring Arab states seeking some sort of refuge from the political and social instability in these areas and, also, from surplus capital generated by the recent oil-boom within the region. A number of the indigenous banks established at

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14. A.E. Asseily, loc. cit., pp.31-32.

this time did survive the early years and went on to prosper in the late 1950's. Principle among these banks were Intra Bank (1951); Société Bancaire du Liban (1946); Banque Al-Ahli (1953); Banque du Liban et d'Outre Mer (1951) and Banque Libanaise pour le Commerce (1950: at the present time the largest indigenous bank).

This general laissez faire climate in the banking sector continued to attract in a number of foreign banks, many of whom were anxious to gain a foothold in the Middle Eastern area to benefit from the net capital flows mentioned earlier. Some of the earlier expatriate banks to be established were the Algemene Bank (1954), and the Banque Belgo-Libanaise (1953). In some cases foreign banks bought into existing local banks, e.g. Banque G. Trad merged with Credit Lyonnais in 1951, and more recently this has been a very convenient way for foreign banks to enter the Lebanese banking sector as will be seen later in this chapter.

Banking development in the 1950's was very rapid indeed. The overall picture was of many small local banks being established and a fewer, but larger, number of expatriate banks who appeared in this period to be increasing their relative share of the market. Although the number of individual banks increased rapidly, the number of banks which began to develop a system of branches was very small indeed. In fact there was very little incentive

to develop branches. The majority of any bank's business would be in Beirut and the very high cost of building land probably made the marginal cost of a branch bank much more than any potential revenue from increasing the volume of deposits. Some banks established small branches in Beirut, particularly in hotel lobbies, etc. Even by 1973 there was only one bank which could be described as having an extensive branch network.[15] Banking development in the 1950's and the early 1960's was heavily concentrated in Beirut and the unit bank was the most common form of institution.

Whilst the almost complete absence of regulations concerning banking development obviously contributed to this very rapid growth of financial institutions, another powerful element in this development was the Banking Secrecy Law of 1956.

> "Because of its geographic position and of its liberal political regime, Lebanon may become, within a short period ot time, the banker of the Arab states and the refuge of foreign capital. In order to secure for Lebanon this privileged position, a banking secrecy should be established similar to what exists in Switzerland . . ."

Thus runs the preamble to the Banking Secrecy Law of 1956, setting out the Lebanese government's motives for establishing a code of secrecy.[16] Above all this law encouraged

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15. The Development Bank - now known as the Continental Development Bank, having been acquired by Continental Illinois Bank. The bank has 33 branches.

16. The Articles of the Law are set out in Appendix 1.

the inflow of foreign funds. The law stipulates that all banks are strictly forbidden from revealing information about the funds of their customers to any person or authority unless authorized by the customer concerned or legal heirs. There are no loopholes to this law, and, in this sense, is much more rigorous than the banking secrecy laws in Switzerland that do allow the Swiss Federal Government to obtain information on certain accounts. There is no doubt that the complete anonymity achieved by this law was crucial in the development of banking in the years after 1956. Pierre Edde, then President of the Bankers Association, wrote in 1963,

> "The affects of the Banking Secrecy Law are in fact felt beyond the frontiers of Lebanon and reach all those who trust our laws, their maintenance and stability; . . . That trust has increased our economic resources and has contributed to our development and prosperity".[17]

The anonymity attached to individual accounts encouraged Arab countries to deposit money in the Lebanon. One consequence of this development has been a rapid growth in total bank deposits and an even more spectacular growth in deposits denominated in foreign currencies. The presence of foreign currency deposits (estimated to be as high as 65% of total bank deposits)[18] is a reflection of the

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17. P. Edde, Letter addressed to the Minister of Finance, March 1963.

18. See Chapter Seven.

limited investment opportunities available in many of the small oil states, where oil royalties tend to be channelled into financial centres such as Beirut. In addition foreign currency reserves are held in Beirut in order to finance the very large multi-national element in trade. Beirut is used as an entrepot from a large part of arab trade in the Middle East and, therefore, foreign currency deposits have been accumulated in Beirut to help to finance this trade.

All these factors conspired to produce a situation when in 1960 the number of individual banks in Lebanon had risen to 60. Of these banks 44 were "Approved banks"; that is their guarantees were acceptable to local and central authorities.[19] By this period Lebanon had developed the most sophisticated banking system in the arab Middle East, i.e., excluding Israel, and in some respects could almost be compared with banking systems in Western Europe.[20] It also shared the distinction with Hong Kong of having the largest number of separate banks per capita in the world.

The amount of inter-bank cooperation in this period was fairly limited. In 1943 the Banque de Syrie et du Liban set up a Clearing Office to facilitate the settlement of inter-bank claims, and in 1953 the same bank

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19. J.O. Ronall, "Recent Banking Developments in the Middle East", The Bankers Magazine, Vol. CXCIII, No.1418, May 1963, pp.407-409.

20. J.O. Ronall, op. cit., p.407.

established a Credit Risk Office, which had the intention of providing a system whereby member banks could exchange information on the credit of their debtors. The first institution was successful in that virtually all banks became members. The second institution was less successful as a number of larger banks were reluctant to impart information, which might put them in an awkward position visa vis the Banque de Syrie et du Liban, which was not only a bank of issue, but also a private commercial bank competing directly with other banks.[21]

In 1959 the Association of Lebanese Banks was set up with the agreed aims of creating more cooperation between banks, in developing common rules and regulations in the public interest and also protecting the interests of the banking profession itself.[22]

Apart from these forms of cooperation, most banks operated in a very individual fashion, unfettered by specific regulations and having the ability to indulge in speculative ventures and unorthodox practices, including investment in real estate and equities.[23] This type of activity partly contributed to the liquidity crises experienced by some banks between 1966 and 1969, which are detailed in Chapter Eight.

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21. T. Yafi, op. cit., pp.86-93.
22. Banque de Syrie et du Liban, Assemblee Ordinaire Generale, Exercise 1959, p.6.
23. S. Hoss, "The Banking System Since 1966", The Banker, p.63.

The year 1960 can be taken as a convenient break point in the development of the banking sector. The tremendous expansion in banking activity up to this date had created one or two undesirable situations which have been referred to already. In particular the Lebanese government became concerned over the proliferation of very many small banks, who, in order to compete for deposits, were offering high interest rates on demand deposits and, therefore, had to finance highly speculative investments in order to show a profit. Interest rates on demand deposits were as high as 5% and 6% during this period. A banking failure due to unwise investments would obviously have repercussions on the whole of the Lebanese banking system, apart from ruining an individual bank. Bearing in mind its need to protect the position of Beirut as an international financial centre, the Lebanese government decided to freeze all applications for bank incorporations, apart from those already being processed. This was done in March 1961 and had the effect of creating a moratorium within which the government could legislate further if it wished to do so. In fact most of the government's intentions became clear only in 1963 with the publication of The Monetary and Credit Act, which not only laid down the articles of organization for the new central bank; but also stipulated the regulations which would henceforth apply to commercial banks

operating in Lebanon.[24] In particular, section III of the Act (articles 128-131) laid down the conditions of establishment for commercial banks and these were such that no commercial bank could be established in Lebanon without consultation with the central bank. It is interesting to note that the word "consultation" was used rather than a stronger word like "permission". The Monetary and Credit Act was published in 1963 and the Central Bank was established in 1964. Therefore, although the government had expressed its intention to control banking activities in 1960, these intentions were not made effective in any sense until 1964 and, in fact, it could be argued that the Central Bank was not able to exercise any authority over the banking system until 1967, i.e. after the crisis of confidence brought to a head by the Intra Bank crash in October 1966. This meant that there was an interim period of about four years when banking activity was under scrutiny, but not yet subject to specific controls. Thus the growth of banking institutions in this period from 1960-1964 continued and in fact accelerated. Of the total of 110 financial institutions[25] registered in 1968, 4 had been established in 1961; 9 in 1962; 16 in 1963 and 8 in 1964.

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24. The Monetary and Credit Act 1963. Decree No. 13513 Published in the Official Gazette No. 62 or 5.8.63. (English translation by M.H. Salloum).

25. The term 'financial institution' refers not only to registered banks, but also to investment companies and discount houses.

Thus 34% of all financial institutions were created in this period.

The warnings given by the Lebanese government in 1960 and the legislation which became effective in 1964 were unable to stop this spectacular growth. From a figure of 60 banks in 1960, the total rose to 82 in 1964, hitting a peak of 88 banks in 1967 and 1968. However of the 88 banks registered in 1968 only 73 were described as active, with the remaining number under government supervision or in voluntary liquidation.[26] This level of 73 banks has been held constant up to 1973.

The number of foreign banks increased rapidly in the early 1960's, with the advent of some major American banks (First National City Bank; Bank of America and Chase Manhattan Bank) and banks such as Bank Saderat (Iranian); Litex Bank (Bulgarian); Arab African Bank (Egyptian); Bank of Nova Scotia (Canadian) and Habib Bank (Pakistan). By 1973, 38 foreign banks had direct interests in Lebanon, either as banks or representatives offices.[27]

An overriding feature of all the banks during this period was their individuality. This is derived from two

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26. Annual figures for the total number of registered banks are given in, Banque du Liban, Rapport su L'annee.

27. In this latter category come Barclays Bank International; Deutsche Bank; Dresdner Bank; State Bank of India; Bank of Tokyo, to name a few, see Association des Banques du Liban, Rapport Annuel 1973 and Appendix 2.

main sources. Firstly, until 1960 individual banks had no need to publish any balance sheets or accounts of their activities. This meant that individual banks were very guarded in their attitude to other banks. Secondly, prior to 1964, no central bank existed in Lebanon. One consequence of this was that no organized call money market existed, although there was a rudimentary inter-bank loan market, described earlier in this chapter. The Banque de Syrie et du Liban (BSL) acted as a central clearing house and issuer of currency prior to 1964. An account of its activities prior to 1964 give some indication of the nature of controls which existed in the pre-Central Bank era. The BSL, a French bank, was established in 1919 and immediately took over the function of note issue from the Ottoman bank. The privilege to issue currency was formally recognized in a charter of 1924 and subsequently renewed until 1st April 1964, when the right expired and the Banque du Liban, the new central bank, took over this function. Up to 1964 BSL had pursued the following central banking activities; it was a bank of issue, the government bank and banker to the banking sector. A separate issue department was established to deal with the first function. One interesting aspect of this issue function is that the gold cover for the Lebanese pound rose as high as 92% in 1961. The gold cover specified in the 1924 charter was 45%. In 1937 this dropped to 10%, with the

majority of reserves held in french francs and french securities. A new Monetary Law of 1949 required the cover on the note issue to be at least 50% gold and foreign currencies easily convertible into gold. A favourable number of balance of payments years in the 1950's meant that the BSL had the opportunity to purchase gold, thus building the gold cover up to its extraordinary level by 1961. This trend has been continued in more recent years as can be seen from Table 5.1

Table 5.1: Gold cover of the fiduciary issue: 1964-1973
(in millions Lebanese pounds)

Year	Gold and Convertible Currencies	Fiduciary Issue	Gold Cover
1964	465	533	87%
1965	481	571	84%
1966	497	574	87%
1967	631	730	86%
1964	702	801	88%
1969	775	910	85%
1970	767	898	85%
1971	743	872	85%
1972	835	981	85%
1973	935	1068	87%

Source: Bulletin Statistique Mensuel.

Notes: The figures relate to the holdings in January of each year, except for 1964 and 1965 where the month used was April. The monthly variations are sufficiently slight to justify this procedure.

This very high gold cover for the fiduciary issue has been very important in the development of the banking sector. Gold, until recently, was still used as a major trading medium in the Middle East and the fact that the gold cover for the Lebanese pound was so high created a general air of confidence, which encouraged capital inflows into Lebanese banks from other arab areas of the Middle East.

Technically speaking, the BSL acted as a bank of issue for both Lebanon and Syria for a large part of its history. When the issuing charter of 1924 expired in 1937, the BSL concluded two separate agreements with the Lebanese Republic (May 29th, 1937) and the Syrian Republic (February 25th, 1938) which continued until 1956 in the case of Syria and 1964 in the case of Lebanon.[28] Although the BSL had jurisdiction in both countries, the following account of its activities applies exclusively to Lebanon.

A second function of the BSL was to act as banker to the government. Most of the Lebanese government's funds were deposited with the BSL prior to 1964, and the rates paid by BSL on these public deposits generally tended to follow the rates of the Banque de France, thus emphasising the close relationships between the Lebanese banks and the french financial system. The BSL also loaned money to

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28. The Lebanese and Syrian currencies were gradually separated from 1938. Syrian bank notes were finally taken out of circulation in Lebanon in 1948, at the same time as Lebanese pounds were withdrawn in Syria. This lead the way to the creation of two separate monetary systems.

public utilities in Lebanon. The BSL was also involved in any interventions the Lebanese government wished to make in the foreign exchange markets. Under the Exchange Equalisation Fund of 1949, the BSL had the authority to enter the foreign exchange market; but its first intervention only occurred in 1953 when it was asked to support the U.S. dollar rate at a minimum of LL3.20 = $1. The exchange equalisation function of the BSL was never clearly defined and very little used, and Lebanon has enjoyed a virtually freely fluctuating exchange rate over the last twenty years. The BSL was assisted in its foreign exchange function by a number of agreements negotiated with the French government, which guaranteed the franc reserves held by the BSL. The latest of these agreements was the one of January 24th 1948, which, among other things, allowed the Lebanese government to convert its franc holdings into gold, leading to the rapid rise in gold holding commented upon previously.

The third and final function of BSL was to act as a banker to the commercial banking sector. It is interesting to look at this function in some detail to see in what ways the BSL was able to influence the development of the commercial banking sector. An obvious drawback to the BSL acting as a banker's bank was that it was a commercial bank itself. Thus if a commercial bank was in need of rediscounting facilities, which the BSL provided then that bank

was at the same time demonstrating to the BSL that it was in need of funds: the sort of confidences that commercial banks do not normally share amongst each other. The BSL acted in three specific ways to assist commercial banks. It provided rediscounting facilities, on bills carrying three signatures. The discount rate used was that set by the Banque de France until 1953. Thereafter it remained at 3%. Secondly, the BSL was prepared to open lines of credit for commercial banks. These credits were usually granted for up to a year's duration. Finally the BSL was prepared to buy bills from banks for cash on a seven day basis, on the assumption that the banks would repurchase the bills at the end of the seven days. This facility was designed to provide immediate cash for banks suffering from illiquidity. This last facility was used more than the other two by the commercial banks, which would suggest that short run illiquidity was one of the major problems in the banking sector during this period.[29]

This list of facilities offered by the BSL to the commercial banking sector gives the impression that a fairly wide range of control was possible and that there was the possibility for orderly relationships to exist between banks. Actual experience fell short of this.

Hoss summarising the activities of the BSL states,

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29. A.E. Asseily, loc. cit., p.169.

> "The BSL performs at present some of the functions of a central bank in Lebanon - but it exercises no monetary control and acts only reluctantly as a lender of last resort. The BSL is under no legal obligation to regulate the money supply for a specified purpose or in a specified manner. Nor is it under the existing conditions capable of regulating the money supply effectively. Its ability to exercise effective monetary control is handicapped by the fact that it has no jurisdiction over the other banks in Lebanon and by the fact that the securities market is not well developed . . ."[30]

The ineffective control exercised by the BSL revolves around the complicated nature of its relationships with other commercial banks. It is clear that the BSL was in a rather unusual position. It was ostensibly a commercial bank required to carry out certain central banking functions. To do this successfully it must, presumably, be able to demonstrate its impartiality towards all other commercial banks. But this is very difficult to do if the BSL is itself competing for deposits and granting advances like other commercial banks. The general position that a commercial bank acting as a central bank, or a central bank acting also as a commercial bank might find itself in is aptly summarised by Jucker-Fleetwood.

> " the central bank either through the bankers' association, through special meetings or even by the most informal talks, lets it wishes . . . . be known. If the position of the central bank is good and it has the confidence of the banking community this informal control is often far reaching and efficacious.

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30. S. A. Hoss, The Roles of Central Banking in Lebanon, Ph.D. Thesis, University of Indiana, 1961, (Ann Arbor: Michigan, University Microfilms Inc, 1962) p.110.

> Should a central bank itself be operating in the commercial field, it would either find that one department must control the other on a par with the other banks or it would be tempted to make exceptions for its own department on the grounds of greater national interest. Both policies are difficult to enforce. The former demands a high degree of impartiality and objectivity - and even when the regulations are scrupulously and meticulously enforced the rest of the banking community will find this hard to believe. The resulting suspicions will make the task of the central bank even more difficult than already is the case. This applies doubly to the alternative policy of excepting the central bank's commercial department . . . from the regulations of monetary control."[31]

This general comment made by Jucker-Fleetwood gives a clear indication of the potential dangers of allowing a commercial bank to adopt central bank functions, like the BSL. An alternative idea is presented by Professor Sayers when he puts forward the view that in some cases a central bank should develop commercial bank facilities to encourage the growth of commercial banking in the country concerned. This does not seem to be a valid argument in Lebanon as the banking sector was adequately developed.[32]

Thus the BSL was placed in somewhat ambiguous position vis a vis the commercial banking sector. Because of this ambiguous position the BSL was never able to extend to the commercial banks all the facilities at its disposal. This is particularly true of rediscounting facilities.

It is possible to suggest, though difficult to prove

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31. E.E. Jucker-Fleetwood, Money and Finance in Africa, Basle Centre for Economic and Financial Research Series B. No. 6, (George Allen & Unwin, 1964) p.60.

32. R.S. Sayers, Central Banking after Bagehot, (London: Oxford University Press, 1957) p.118.

conclusively, that the position of the BSL was such that it was unable and probably unwilling to apply controls on the commercial banking sector, which resulted in the very rapid, probably over rapid, expansion of banking facilities in the 1950-1960 period. Certainly the lack of specific central bank controls, such as regulations on the size, capital constitution and business pursued by a commercial bank, meant that virtually anyone could start a commercial bank. Once it was started then there were few ways that the BSL could control its activities, yet it was expected to provide short-term cash facilities if it became illiquid. In other words what control there was was probably applied in the wrong place and was not very effective anyhow. In certain cases the activities of the BSL as a central bank and as a commercial bank clashed quite decisively. During the 1948-1960 period the BSL carried out a small number of rediscount operations, with rediscount rates varying between 5-7% p.a. However as a normal commercial bank the BSL tended to expand credit in times of boom and restrict credit in times of slack. Thus rediscounting facilities were most readily available at a time when they were least needed. In certain circumstances the government had to intervene to force the BSL to accommodate the commercial banks. For instance this was done in 1956 and 1958.[33]

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33. T. Yafi, "A Case for Banking Reform in Lebanon", Middle East Economic Papers, 1958, pp.109-114.

This rather long discussion of the BSL is important in understanding the general environment in which commercial banks developed prior to 1964. Asseily has concluded that

> ". . . the BSL was fulfilling its purpose adequately and properly . . ."[34]

This statement is broadly true in that the functions of the BSL were very limited ones. What is more important to our overall analysis is that the BSL was in no position to supervise the very rapid growth of the banking sector prior to 1964 and the excessive proliferation of banks in this period tended to weaken the banking sector rather than strengthen it. The numerous banks which have gone into liquidation since 1966 suggest that Lebanon was over-banked. Each liquidation has created a certain crisis of confidence in the banking sector as a whole, whereas these crises could have been avoided if appropriate controls were available at a much earlier date.

To bring our survey of banking developments up to date, we must now consider the period from 1964 to the present day. This period represents a time of considerable change. A new central bank was established in 1964 and the commercial banks might be said to have consolidated their position since then. The total number of commercial

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34. A.E. Asseily, loc. cit., p.177.

banks operating in Lebanon reached a peak in the 1967-1968 period with a total of 88 banks registered with the Central Bank owning a total of 232 branches between them (excluding 3 branches open only during the summer tourist season). Since 1968 the total number of banks in operation has dropped to 73. Of this total 34 are completely indigenous banks; 20 are jointly owned by Lebanese and foreign elements and 19 are completely foreign owned. It is instructive to note that all 17 banks that have dropped from the list of registered banks since 1966 were indigenous banks. Nine others acquired a foreign participation and five more came completely under foreign control. Thus it is the indigenous banks alone that have suffered by the events of 1966 onwards.

October 1966 saw the collapse of Intra Bank, at that time the largest commercial bank in Lebanon. Whilst a more detailed account of the collapse is given in Chapter Eight, it is important at this stage to emphasise why this particular bank collapse was important. Intra Bank, like many indigenous banks at that time, had a considerable proportion of its assets in very long-term, high-risk ventures and hence its liquidity position was very serious indeed. A few rumours about Intra's position was sufficient to cause a run on the bank. The Intra Bank closure affected other banks in the system both directly and indirectly. Firstly the general uncertainty caused

runs on other banks and secondly, the Intra crash virtually forced the Central Bank into action.[35] It was clear that a number of controls were necessary for the overall benefit of the banking sector. In particular the Central Bank was anxious to maintain a very close watch on liquidity ratios within individual banks. From 1968 onwards all banks have submitted a brief statement of their liquidity position to the Central Bank each month and more detailed statements have been submitted every quarter. In addition in 1969 the Central Bank required all commercial - banks to deposit 5% of their total deposits with the Central Bank in Lebanese pounts.[36] This measure had a two-fold effect. It put considerable pressure on local banks to increase their liquidity (it was reported at the time that even a 5% liquidity level was proving embarrassing to some banks) and it forced many foreign banks to convert foreign currency holdings into Lebanese pounds to meet the 5% requirement. This had the side effect of reducing pressure on the Lebanese pound which was gradually depreciating in late 1969 and early 1970.[37]

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35. J.N. Bridge, "Reforms Strengthen Banking", Financial Times Survey of Lebanon, November 30th 1971, p.28.

36. The detailed effects of these policies are discussed in Chapter Eight.

37. J.N. Bridge, "The Lebanese Pound", International Currency Review, September/October 1970, p.3.

The financial system that has emerged in 1974, in the wake of central bank reforms, in now a smaller and stronger one than that which existed at the height of the banking boom in 1966. Total deposits in the banking system by mid-1974 had risen to a total of LL7,819 million (compared with LL3,453 million in September 1966). The squeeze on liquidity after 1966 affected the indigenous banks more than the foreign banks. This was for two main reasons. Firstly, fewer foreign banks were involved in long-term speculative ventures and secondly, foreign banks had recourse to their overseas headquarters for any injection of liquid assets that might be necessary. The major result of these two factors has been that the foreign banks , as a group, have become more dominant within the financial sector. In terms of concentration thirteen banks hold 60% of all deposits (all of them being foreign bar one). However the consolidation in the banking sector has left the indigenous banks in a stronger position. Whereas total deposits between September 1966 and December 1972 expanded by 69%, the 34 surviving local banks increased their deposits by over 75%. As has been mentioned already, the foreign banks have emerged from this process stronger than ever. All foreign and foreign participation banks accounted for 71% of total deposits in 1966; now they account for 77% of all deposits.[38] Thus the "supra-territorial"

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38. J.N. Bridge, "Reforms Strengthen Banking", op. cit., p.28.

character of banking in Lebanon has intensified.[39]

The period has also been significant in that the Central Bank created in 1964, has emerged as a potentially strong controlling agent.

Thus the Lebanese banking system is now a mixture of extremely large and extremely small banks, in which most but not all of the large banks are wholly or partly foreign owned. The wide variation in size is an important aspect of the Lebanese banking system, since the ability of individual banks to respond to credit or liquidity crises is very much a function of their size.

So far in this chapter the terms "financial sector" and "banking sector" have been used almost synonomously. This is because there has not been any significant development of what Gurley and Shaw call "non-bank financial intermediaries", in Lebanon. However, two major categories of "non-bank financial intermediaries" are worth mentioning here. Firstly there are a number of institutions called banks, which are not accepted as such by the Central Bank. When full information on banking institutions first became available in 1966 and 1967, the total number of banks, "approved" by the Central Bank totalled 88, yet 112 banks were documented in the Commercial Directory for that year. Some of these institutions operated as banks on a very small scale; probably accepting deposits from certain

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39. This term is used by D. Rowan, "Central Banking in the Commonwealth", Banca Nazionale Del Lavoro Quarterly Review April-June 1953, p.132.

families and providing a type of extended internal finance in the commercial sector. Secondly, a number of insurance companies have been classified as banks. By the end of 1973, there were 13 indigenous insurance companies in Lebanon and over 90 branches and agencies of foreign insurance companies. The total volume of assets in the insurance sector is unknown. All that one can say is that foreign insurance companies are increasing rapidly the number of insurance outlets in Lebanon. This is largely in response to not only a demand for insurance facilities in Lebanon; but also a demand in the Middle East as a whole. Many countries in the Middle East either have no or at best a rudimentary insurance sector and foreign companies, in particular, operating in these countries look to Lebanon as a base for securing insurance facilities.

> "Although insurance companies are not a significant source of finance, they are potential sources of funds to specialize credit institutions and industrial corporations in the country . . ."[40]

Whether insurance companies do become significant as suppliers of indirect financial securities to the domestic market will depend on whether indigenous companies can grow independently of foreign insurance companies and provide a viable domestic service.

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40. "The Money Machine: How Healthy", The Middle East Sketch, Vol. 1, No. 42, January 12th 1973. p.48.

The Stock Exchange in Beirut is mainly an instrument for registering stocks and is not in any significant way a vehicle for raising investment capital. This is because,

> ". . . securities are very few, due to the low level of development of the corporate form of business in Lebanon. In this respect, the family-type business as well as some organizational and discal factors handicap the demand side of corporate capital. . ."[41]

Thus, there are intermediaries in the financial sector, other than the recognized commercial banks, but their activities are, so far, of a very limited kind. The next two chapters will discuss the commercial banking sector exclusively, although Chapters Eight and Nine will extend the definition of the financial sector to include the activities of the non-bank financial intermediaries.

The development of the banking sector, especially in the 1960's and early 1970's, has been influenced to a large extent by the degree of liquidity within the banking system. It is the question of liquidity which has occupied the Central Bank most in its dealings with the banking sector. Chapter Six now goes on to discuss the issue of liquidity in more detail.

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41. Middle East Sketch, op. cit., p.48.

C H A P T E R S I X

Liquidity in the Banking System[1]

The banking sector in Lebanon has experienced a number of difficulties over the last decade in terms of the overall liquidity of the system and the general availability of liquid assets and re-discounting facilities. These difficulties have been experienced over a period when the Central Bank has had the power to establish formal reserve requirements, but has not chosen to do so. The general question of liquidity in an unregulated system such as this and the relationship of the Central Bank to the banking sector are the main issues dealt with in this chapter.

The ability of an individual bank or a banking system to redeem liabilities on demand is the most important characteristic of a stable financial system. Therefore, one of the most important criteria by which to judge a

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1. This chapter extends some of the ideas originally presented in J.N. Bridge, "Liquidity in the Lebanese Banking System", Bankers Magazine, Vol. CCVII, No. 1509, December 1969.

banking system is its ability to maintain a stable and sufficient ratio of liquid assets against the total volume of deposits. Liquidity in a general sense can simply be defined as the speed with which an asset can be converted into money. In practice we can distinguish between those assets defined as being liquid by convention, i.e. acceptable to the central authority as part of a liquid assets ratio or we can attempt to distinguish assets in terms of their liquidity on a theoretical rather than pragmatic basis.

In many countries, including the United Kingdom, the ratio of liquid assets to total bank assets is determined by law or convention. Not only is a specific ratio indicated in the United Kingdom; but also the assets and liabilities which are eligible for calculating the reserve ratio are also specified.[2] In this particular case it is easy to recognize whether a bank is illiquid or not based on the criterion established by the convention. However, the case is very much more complicated when a commercial banking system is faced with the need to establish a certain degree of liquidity in the absence of any central authority "rules". This is the case in Lebanon where no such legal requirements exist. Although the Central Bank has statutory powers to impose legal reserve ratios through

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2. "Reserve Ratios: Further Definitions", Bank of England Quarterly Bulletin, Vol. 11, No. 4, Dec. 1971, pp.482-489.

the Monetary and Credit Act of 1963; so far it has not chosen to exercise these powers completely, although amendments to the Act in October 1973 have strengthened the Bank's position (see Chapter Eight). Article 175 of the Monetary and Credit Act states, in part,

> ". . . the Central Bank may periodically determine the proportions which must exist:
> (1) between the amount of the liquid assets of a bank properly classified, on the one hand, and the amount of its obligations classified according to maturity, on the other hand.[3]

This provision puts no obligation on the Central Bank to establish mandatory reserve ratios, nor, surprisingly, does it obligate the Central Bank to treat all banks equally, with respect to reserve ratios. It will be shown later that the Central Bank has exercised its authority with respect to reserve ratios partially but never in any comprehensive manner.

Given this situation each bank has to decide for itself what volume of liquid assets it will hold against total deposits. The problems in this situation are basically twofold. Firstly, if each bank takes s decision about its own liquidity position independently of all other banks, it is possible that the level of liquidity achieved may be greater than is necessary for the system as a whole. Secondly, apart from the problem of the

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3. The Monetary and Credit Act 1963, Decree No. 13513, Published in the Official Gazette No. 62, August 5th 1963. (Translated into English by M.H. Salloum).

level of liquidity, individual banks are faced with the problem of the types of assets that can be considered liquid. Let us consider these two points in more detail.

Intuitively the question of the level of liquidity can be answered by considering the position of the Central Bank. If the Central Bank does not establish any formal liquid reserve ratio, then presumably each bank has to assume that it is operating individually. Its objective view of the risk attached to the possibility of illiquidity will be greater than if all the banks act collectively under a rule given by the Central Bank. This intuitive argument can be presented in a more rigorous form. Let us assume that x_i is the amount of money demanded on call from the i^{th} bank, that A_i represents the total assets of the i^{th} bank and L_i represents its liquidity ratio. Let us assume that the probability of default is defined as follows:

$$P\{x_i > A_i L_i\} < \varepsilon$$

Let us assume further that the demand for money at call is normally distributed such that:

$$x_i \text{ is } N(\mu_i, \sigma^2)$$

$$\therefore \quad A_i L_i = \mu + \lambda_i \sigma,$$

where λ_i is the indicated value which is the limited imposed by ϵ.

$$\therefore \quad L_i = \frac{\mu + \lambda_i \sigma}{A_i}$$

This expression will give the liquidity ratio for the $_i$th bank. Now let us repeat the procedure for all banks. Again let us assume that all banks independently have demands for money at call which are normally distributed. Thus,

$$\Sigma x_i \text{ is } N(n\mu, n\sigma^2)$$

The probability of default is defined as previously:

$$P\{\Sigma x_i > L\Sigma A_i\} < \epsilon$$

$$\therefore \quad L\Sigma A_i = n\mu + \lambda\sqrt{n}\,\sigma$$

$$\therefore \quad L = \frac{n\mu + \lambda\sqrt{n}\,\sigma}{\Sigma A_i}$$

This expression gives the liquidity ratio for the banking system as a whole. If this is divided through by n, it can be seen that the average obtained in less than the term for the single bank. If a Central Bank is in a position to determine the liquidity ratio for the system as a whole then that ratio will be less than if each bank sets its own rate independently, assuming that the probability of default is the same in each case, and that the Central Bank acts rationally and does not wish to establish excessively high liquidity ratios.

Assuming the Central Bank is prepared to act as a lender of last resort to the banking system, then a given liquidity ratio will act as both a minimum and a maximum for each bank. In this case the risk is reduced to zero, that is assuming the Central Bank has the power to cover any risk of default by an individual bank. Therefore the liquidity ratio established under a Central Bank regime should be less than that established under a regime where all banks act independently.

One of the implications of this conclusion is that if banks are required to hold "excessive" volumes of liquid assets in the absence of a Central Bank "rule", then this will inhibit growth in long-term investment. In other words the absence of a formal reserve ratio requirement reduces the time profile of a typical bank's portfolio. In practice one can expect a certain amount of dependence

among banks in that they may be all participants in the short-term inter-bank loan market, and, therefore, their liquidity is dependent on the behaviour of other banks. More specifically, the ownership of specific assets by certain banks may predetermine what is acceptable as a liquid asset for the system as a whole. This brings us to the second point which concerns the types of assets that can be considered liquid.

Traditionally liquidity has been defined as the speed with which an asset can be turned into cash. In more general terms we can see it as a measure of the degree to which any financial intermediary can meet its total liabilities at a particular moment in time. However, a rather difficult theoretical problem emerges in that any particular asset may have differing liquidity characteristics over time. This problem is largely surmounted if a Central Bank declares itself ready to recognize certain assets as being liquid and is prepared to provide cash for banks on the basis of these assets. For instance in the United Kingdom since September 1971 specific assets have been deemed 'eligible' for calculating reserve ratio requirements. These eligible assets include head office balances and balances with the Bank of England, Government Treasury Bills, money at call, local authority bills eligible for rediscount at the Bank of England, to mention a few.[4] This

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4. "Reserve Ratios: Further Definitions", op. cit., p.485.

group of assets is recognized as being eligible in the sense that the Central Bank (the Bank of England in this case) is prepared to accept these assets as part of a liquidity requirement; but, presumably, and this is the more important point, is prepared to redeem these assets in full in case of crisis. In other words specified assets of this sort do not lose any of their liquidity if financial conditions change dramatically.

A problem does exist if the Central Bank does not recognize specific assets as being liquid. The acceptability of an asset as a liquid asset is not solely a function of its maturity in this case. Its liquidity is also a function of the confidence that the banking community has in the holder of the asset. In other words, two banks may hold identical portfolios of liquid assets; but one may be judged to be more liquid than the other, dependent upon subjective judgements of the individual banks, and the attendent economic circumstances. To illustrate this last point let us consider an example from labour economics.[5] In a fully employed economy the skills of a worker are liquid in that a number of jobs may be available into which the worker could move. In an unemployed state these same skills now may become totally illiquid in that there is now an excess supply of these

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5. A. Leijonhuvud, Keynes and the Classics, I.E.A. Occasional Paper No. 30, July 1969, p.32.

skills on the market. So, although the skills of the worker, i.e. his assets, remain unchanged, the demand for these assets has changed; thus changing the liquidity of this particular asset or skill. It is this additional perspective which prompted Schmoelder to define two types of liquidity:[6]

a) objective liquidity - this is based on the actual liquid assets and credit facilities available.

b) subjective liquidity - this is based on an assessment of potential liquidity to be derived from a particular privileged position.

Subjective liquidity may have an internal and an external aspect. Certain standards that may be adopted by social groups may restrict the use of certain assets as a means of liquidity. Schmolders indicates that the drawing or accepting of bills in order to raise money may be restricted in such a way as to create a position of liquidity, less than the 'objective' one. This is an illustration of the internal aspect of subjective liquidity. Equally a specific groups of assets may take on differing liquidity characteristics based on external influences, such as business cycles. An increasing demand for bank credit during an upswing in business activity may encourage bankers to reduce their total liquidity position (in an absolute sense) thus expanding business credit and creating

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6. G. Schmolders, "The Liquidity Theory of Money", Kyklos, Vol. XIII, No. 3, 1960, pp.345-360.

increased purchasing power. In this situation expectations and liquidity act one upon the other, such that a lower level of absolute liquidity is achieved whilst maintaining the subjective level of liquidity the same, i.e. as the total volume of liquid assets is reduced increasing confidence in the present stock of assets compensates fully for the initial reduction. On the other hand,

> ". . . liquidity disappears . . . by pessimistic business expectations, e.g. by spreading fears of diminishing profits, labour conflicts or other difficulties. . ."[7]

One implication of this analysis is that a fixed reserve ratio requirement cannot be optimal over time. If the reserve ratio requirement is optimal for business depressions, it will mean that there will be excess holdings of liquid reserves in boom periods. Dependent on the rates of return on liquid assets this type of policy can have an adverse effect on bank earnings.[8] Any bank seeking to maximise profits subject to a specific liquidity constraint will obviously not like a situation where that liquidity constraint is greater than is necessary for the prevailing economic conditions. Equally, if it is argued that banks provide a socially important

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7. G. Schmolders, op. cit., p.354.

8. R. Goode, and R.S. Thorn, "Variable Reserve Requirements against Commercial Bank Deposits", International Monetary Fund Staff Papers, Vol. VII, 1959-60, p.9-45.

service in that they provide safe deposit facilities for depositors and facilitate lending and borrowing operations through the process of intermediation, then the level of reserve ratio requirements becomes crucial.

The conclusions from this analysis is that variable reserve ratio requirements are preferable to fixed reserve ratio requirements. Secondly, if these ratios are imposed by a Central Bank, the level at which they operate will generally be lower than if each bank operates independently. Equally when a bank has to assess its own level of liquidity individually, then it is not going to have any absolute scale to judge its liquidity against and, therefore subjective factors as well as objective factors will play an important part in determining the level of liquidity desired by the individual bank.

It is also clear from what has been said that in a system where reserve ratios are not specified, it will be impossible to establish a common level of liquidity for the system as a whole. Even in the United Kingdom where banks operate under a reserve ratio rule observed liquidity ratios are not necessarily the same for each bank. In an unregulated system, where subjective factors may be more important, one might expect the divergence from some mean to be even greater. In practice this has been the position in Lebanon over the last ten years.

To understand the problems that exist in Lebanon, it is necessary to look at the liquid assets structure of the banking system.

Liquid Assets Structure

We must examine all liquid assets rather than the cash ratio alone. In Lebanon the volume of cash held by each bank, in local currency, tends to fluctuate quite widely. This is because many banks hold foreign currency deposits, which, although not technically defined as cash, can be easily converted into local currency although some loss on the exchange may be incurred. Most banks appear to be more sensitive to their overall liquidity ratio than to their cash ratio.

We have already seen that although there are a large number of individual banks, transactions are heavily concentrated in a small number of them. The wide variations in size and the fact that most of the larger banks are totally foreign owned or partially foreign owned is an important aspect in discussing liquidity ratios, since the ability of individual banks to respond to credit or liquidity crises is very much a function of their size.

As the banking system as a whole is not subject to mandatory reserve requirements, the ratio of liquid assets

to total deposits is largely an inverse function of the individual bank's ability to call on surplus funds (either through a head office in another country, in the case of a foreign-owned bank, or through the Central Bank in the case of an indigenous bank).

In the absence of a Central Bank rule, the types of assets which are considered by individual banks to be liquid cannot be defined precisely. However, within the Lebanese banking system certain conventions of acceptability have evolved, although it must be pointed out that they do not necessarily apply equally to all banks. However liquid assets are normally defined to comprise vault cash, inter-bank deposits, net foreign currency assets and short-term investments abroad.[9] The types of assets that can be considered as liquid is restricted by the fact that there is no active call money market in Lebanon and there is no significant issue of short-term government debt.[10]

Net foreign currency assets are considered as close substitutes for cash, largely because there is a very active market for foreign exchange; the Lebanese pound has been relatively stable, although it has been allowed

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9. This list was initially compiled from S. Hoss, The Roles of Central Banking in Lebanon, Ph.D. thesis, Indiana University 1962 (Ann Arbor, Michigan: University Microfilms Inc. 1963).

10. There has been a limited issue of government Treasury Bills, which is commented upon later on.

to fluctuate freely and thirdly the importance of expatriate banks, coupled with substantial foreign currency deposits, has meant that cash withdrawals may be made in foreign currencies.[11] Quite clearly there is a difference between cash and foreign currency assets, as there is always a foreign exchange risk involved in converting these assets to cash. Therefore, banks, from time to time, must be attentive to the ratio of cash held in Lebanese pounds. Bearing this point in mind, it is instructive to compare the ratio of cash and inter-bank deposits to total deposits. Before discussing some general trends in liquidity, more detailed figures are provided for 1967, the first year when detailed balance sheets were published by all banks. It must be remembered that although all banks now issue annual statements, the convention for presenting data are not consistent. In addition the information is often available only two years later. However, bearing these two points in mind, 64 balance sheets were examined for the year 1967. One of the findings is summarized in Table 6.1.

Thus the overall ratio of cash and inter-bank deposits to total deposits was 46% in 1967. This is a weighted average, weighted by the number of banks in each group and their contribution, as a group, to total deposits in the

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11. S. Hoss, op. cit., p.39.

Table 6.1: The Ratio of Cash and Inter-Bank Deposits to Total Deposits 1967

	%	No. of banks in sample
Foreign owned banks	65	14
Indigenous banks	38	40
Jointly owned banks	64	10
Overall weighted average	46	-

banking system as a whole. What is more instructive is that the ratio for totally owned foreign banks was 65%, whereas the ratio for indigenous banks was only 38%. This ratio applied to 1967, when a full collection of balance sheets became available for the first time. However there are two principle problems involved in extending the series from 1967. Firstly, the accounting conventions used by each bank were not, initially, standardized and hence conventional definitions of particular assets do vary from bank to bank and from year to year. Secondly, some banks have had a change of ownership, in that some wholly-owned indigenous banks have become foreign or joint-participation banks. Hence the sample groups are not consistent over time. Bearing these points in mind balance sheets for the period 1967-1973 have been examined. This exercise has been assisted to a certain extent by the publication since 1970, by the Association of Banks in Lebanon, of a

standardized list of balance sheets. The Central Bank also began to issue a note on liquidity ratios in 1967 in its Annual Report.[12] The figure for 1967 was 46.1%. Although the Central Bank published no details on how this ratio was calculated subsequent discussions with the Central Bank confirm that the categories of assets used in this thesis are the same as those used by the Central Bank (this of course is unofficial information). The liquidity ratios from 1967 to 1973 are summarized in Table 6.2.

Table 6.2: Liquidity Ratios, Based on Balance Sheets Returns of the Commercial Banks 1967-1973

Year	%
1967	46.0
1968	52.7
1969	52.5
1970	56.2
1971	57.3
1972	57.7
1973	54.2

Source: From the procedures explained in the text.

Notes: The liquidity ratio refers to the position of December 31st of each year.

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12. Banque du Liban, Rapport Annuel.

Very little data existed prior to 1967 which would allow for a long-term assessment of liquidity trends. However, two sources of information are available which are worth mentioning. Asseily calculated the ratio of cash, Central Bank balances, money at call and short-term commercial bills against total deposits and produced a ratio of 42% for 1964 and 41% for 1965.[13] These ratios were calculated on a ratio of liquid assets which included commercial bills and, therefore, overstate the degree of liquidity in the system compared with the later figures. If these figures are standardised by abstracting commercial bills from the numerator the revised ratio becomes 30% for 1964 and 28% for 1965.

Similar calculations were made by Hoss for the period 1956-1960.[14] Unfortunately the number of banks that were able to supply consistent data for the period was very limited indeed, although the ratios quoted do correspond closely with the ones for the period 1967-1972 as far as the classification of assets is concerned. Bearing these points in mind the data used by Hoss yielded the following ratios:

1956	36%
1957	29%
1958	34%
1959	35%
1960	37%

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13. A.E. Asseily, Central Banking in Lebanon, (Beirut: Khayat Publishing Co., 1967) p.48-49.

14. S. Hoss, loc. cit., p.41.

These fragmentary figures for the period 1956-1973 cannot obviously be subjected to a very thorough analysis, due to the inconsistency of the data and the changes in the classifications of assets throughout the period. However it does seem as though the general level of liquidity in the banking system declined gradually in the early 1960's and then increased quite dramatically in the latter part of the period. This trend is consistent with the hypothesis advanced earlier, that liquidity in an unregulated banking system has a subjective aspect to it, such that liquidity ratios will tend to fall in a boom situation (which is true of Lebanon in the period 1959-1966) and will rise in a depression (the depression in this case being the collapse of the Intra Bank in 1966 coupled with the Six-day War in 1967).

One interesting feature of the trend in liquidity since 1967 is that it is not only explained in terms of banks acquiring more liquid assets; but also by the withdrawal of a certain number of highly illiquid banks from the system during this period. Thus the average level of liquidity has risen and at the same time the dispersion aroung the average has probably reduced.

An interesting point arises from the figures quoted in Table 6.1. The foreign banks not only maintain the highest ratio of liquid assets, but also presumably, have recourse to funds from their office in other countries in

case of emergencies. So, on these two counts the foreign banks are more liquid than the local banks. This situation seems to be rather incongruous. Why should the foreign banks maintain higher liquidity ratios when they are able to call on assistance from other overseas offices? This apparent paradox can be explained in at least two ways. Firstly 1967, the first year for which a liquidity ratio was calculated, was an untypical year. The failure of Intra Bank in October 1966 coupled with the Middle Eastern war of June 1967, created a great deal of uncertainty in the banking system. The banks responded to this uncertainty by increasing their liquid assets as much as possible. The figures for 1967 would suggest that the foreign banks were more successful than the local banks in doing this. This argument would suggest that in 1967 the banking system attempted to become more liquid. Once the features which caused the desire for more liquidity are removed one would assume that the general level of liquidity would fall again. This does not seem to have been the case. The second explanation, more plausible in my view, runs on the following lines. The local banks, even at a 38% ratio, were illiquid in 1967. Therefore the level achieved by the foreign banks, far from being an over-liquid level, was the appropriate one for the conditions. Thus the situation at the end of 1967 was not one where the foreign banks were too liquid but one where the local banks were

not liquid enough. This view can be substantiated by considering the activities of the Central Bank in the period from 1967-1969. In this period eight local banks ceased commercial operations and were brought under the control of the Central Bank.[15] In each case the reason for closure was an inability of the individual bank to meet the cash demands put upon it. The liquidity ratios maintained by the foreign banks may seem high in comparison with those in Western Europe. However a considerable portion of the foreign banks' liquid assets are held in the form of foreign currency deposits in overseas money markets. The relatively high rates of interest earned on these deposits seems to compensate for any exchange risk that might exist. In addition some customers of the foreign banks may demand cash denominated in foreign currencies which removes the exchange risk entirely. The precise ratios that the foreign banks regard as adequate in terms of local currency cash, foreign currency cash and short-term foreign currency deposits is impossible to determine. Through private interviews with a number of foreign bankers the overall impression conveyed is that exchange risks are not an overriding consideration in determining these ratios and holdings in the local

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15. These closures are discussed in more detail in Chapter Eight.

inter-bank market can fully cover any excess demand for cash by the public. It is the activities of the inter-bank market that we now need to go on and consider.

Yields on Liquid Assets

An important aspect of these liquid assets is their earning capacity. In Lebanon there is no recognizable short-term money market, neither is there any market for commercial bills, or short term government securities, except, as has been noted, for a limited issue of Treasury Bills. Therefore most of these liquid assets have a low earning capacity, except for those short-term deposits made by the foreign banks, in particular, on various European money markets. There is a fairly active market in inter-bank deposits. The chief function of this market seems to be to provide additional liquidity to individual banks experiencing drains on their cash reserves. The normal procedure is for a bank, in need of extra liquid resources, to borrow from a bank that has excess liquidity, at some agreed rate of interest, which is related to that obtainable abroad. This type of transaction takes place in both Lebanese pounds and in foreign currencies. When foreign currencies are borrowed, it is normal to deposit these with the Central Bank and then draw on this balance

in Lebanese pounds. The interest charged for loans in foreign currencies is usually higher than that charged on Lebanese currency loans, because it is necessary to offer holders of foreign currencies an inducement to stay in Lebanon. There is much less temptation to move excess liquid reserves of Lebanese currency abroad, because this involves an exchange risk in the transfer and therefore the incentives to maintain funds in Lebanon need not be so high. This places the foreign banks in a slightly more advantageous position in the inter-bank market, firstly, because they are the largest holders of foreign currency and therefore tend to earn the higher rates of interest, and secondly, because with their higher liquidity ratios they tend to be net lenders in the market.

The total supply of funds to the inter-bank market is partially determined by the rates of interest obtainable on foreign currency assets abroad. It has often been the practice among bankers in Lebanon to maintain an equality between their foreign currency assets and liabilities.[16] However there has been an increasing tendency over the last ten years for a steady accumulation of net foreign assets to take place. This means that bank deposits initially denominated in Lebanese pounds are being converted into foreign currencies and deposited in overseas

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16. A.E. Asseily, op. cit., p.111.

markets. This obviously implies that the margin between domestic interest rates on inter-bank deposits and short-term overseas rates is sufficiently large to induce this sort of movement. Not surprisingly the Association of Banks in Lebanon in its annual report in 1972 highlighted the rise in interest rates in the Euro-dollar market as being the major economic factor behind the rapid rise in foreign currency deposits in the banking system since 1967.[17] This means that the total flow of funds into the inter-bank market is partially determined by the general level of interest rates prevailing overseas.[18] A second influence on inter-bank deposits is the prime discount rate operated by the Central Bank. If the Central Bank will rediscount paper at, say, 5% (this was the official rate on paper possessing two signatures in December 1967, it dropped to 3% in July 1971), then inter-bank deposits must be offered at this, or some lower rate to induce bankers to take up inter-bank deposits, rather than rediscount bills with the Central Bank. So, provided there are first class bills available there is a ceiling to interest rates on inter-bank deposits, viz that rate

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17. Association of Banks in Lebanon, Annual Report 1972, (Beirut: Imprimerie Catholique 1973) p.28.

18. Specific rates for a long period are impossible to obtain; but an indication of the margin referred to may be deduced from the fact that inter-bank deposits in Lebanese pounds in 1967 and 1968 were earning, on average, 3 - 4%, whilst short-term foreign currency assets were earning 8 - 9%.

at which the Central Bank will discount these bills. In practice the range of interest rates and the flow of funds within the market are more complicated than these few points indicate. There is competition among banks for deposits, leading to differential rates being offered by different banks on similar deposits. Equally depositors are attracted to certain banks by non-monetary attributes, primary among which is the alleged solidarity of the bank.[19] These two factors lead to banks competing on different terms within the inter-bank market. The preference depositors seem to have for foreign banks means that these banks tend to offer lower rates of interest on deposits than local banks and hence find themselves in a privileged position in the inter-bank market. Within the market loans may be secured in Lebanese pounds or in a specified foreign currency. Thus the actual rate on the depsit will not only reflect the direct demand for it; but also and exchange risk premium depending on the currency involved. Loans in Lebanese pounds are affected by the exchange risk premium in the following manner. If the premium is high this will tend to increase the overall demand for local currency loans, thus tending to raise the rate. If the premium is low, this will reduce the demand for local currency loans and thus reduce the rate of

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19. In a period of bank failures this is an important attribute.

interest. We can examine these relationships in more detail. Figure 6.1 indicates the supply and demand conditions in the foreign currency market. Figure 6.2 indicates the situation in the domestic currency market. The supply curve (Sf) in fig. 6.1 is infinitely elastic, implying that the total demand by Lebanese borrowers is not significant in terms of the world market. Thus Lebanese borrowers can borrow as much as they like at the prevailing rate. The demand for foreign currency assets (Df) is upward sloping indicating that as the risk premium increases there is a reduced demand for assets at a given world rate. The demand curve (Dd) and the supply curve (Sd) for local liquid assets are assumed to react normally to interest rate changes. Initially $r_f = r_d$, indicating that all banks have distributed their liquid assets portfolio to maximise profits. In this case the foreign exchange risk premium is zero. Now let us assume the risk premium becomes positive. This means the actual earnings on foreign currency assets is reduced. This can be indicated by reducing the earning rate to r_f'. The difference between r_f and r_f' indicates the risk premium. Now $r_d > r_f'$. This will induce banks to switch to local currency assets thus raising the rate on these assets.[20] Equilibrium will be restored when the domestic

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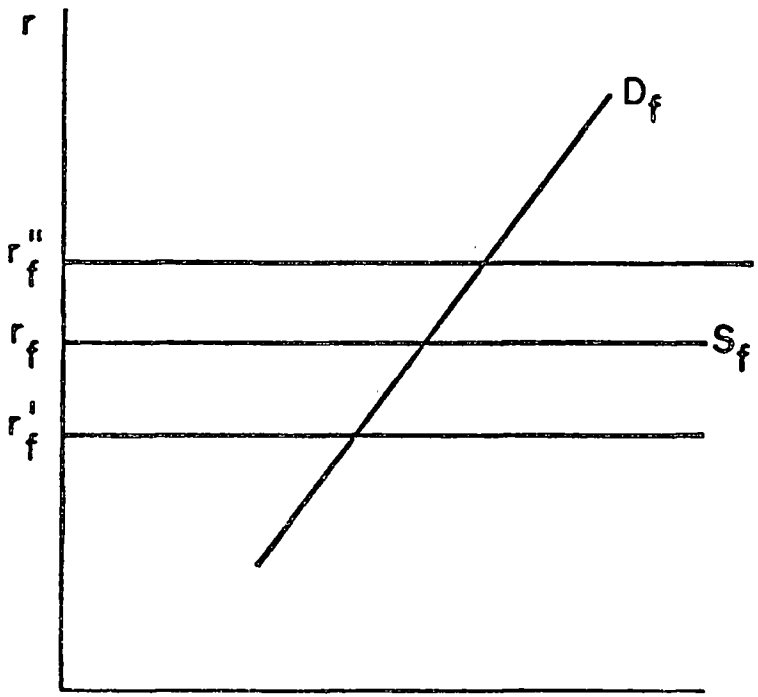
20. Equally if the demand for local currency assets is very low, this will mean that foreign banks, in particular, may be willing to accept a high risk premium.

THE RELATIONSHIP BETWEEN FOREIGN AND DOMESTIC CURRENCY MARKETS

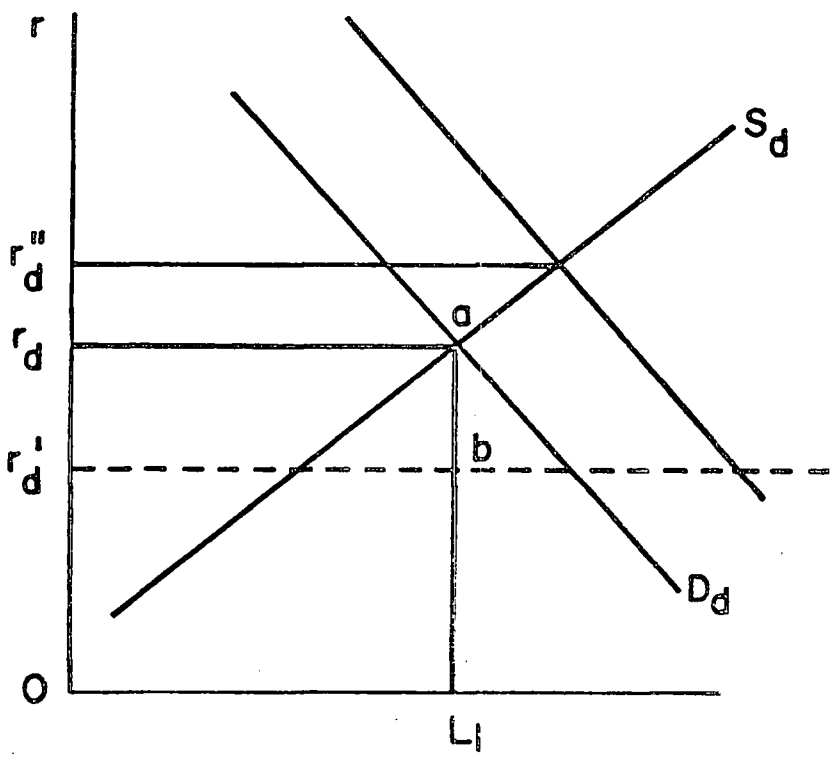
FOREIGN CURRENCY MARKET



Liquid Assets

Figure 6·1

DOMESTIC CURRENCY MARKET



Liquid Assets

Figure 6·2

rate is just equal to that rate in foreign markets which compensates borrowers at the original rate r_f, plus the risk premium. This is rate r_f'' in figure 1. We can introduce rates offered to depositors by banks into this analysis. If r_d' is taken as the average rate payed on savings deposits, then the difference between r_d' and r_d, in the first case, gives the gross earnings of the bank, (more specifically OL, a r_d - OL, b r_d'). If we were to assume the banks incur no costs or make no profits then the equilibrium rate r_d would indicate the maximum rate that banks would be prepared to pay on deposits in local currency. Quite clearly if the foreign exchange risk premium increases, the rate that can be offered to depositors may also increase.

The analysis presented so far has attempted to show in a schematic form the inter-relationships that exist between different rates in the inter-bank market. A further influence on this market is the volume of short-term government debt available to the banks.

Treasury Bill Issues

In 1966 the Central Bank made, for the first time, a limited Treasury Bill issue, quite different from those to which we are accustomed in the United Kingdom. It issued

LL40 million of bills with varying maturities (20% after one year, 40% after two years and the remainder after three years). The rate of interest was set at 3¼% for the first year, 3½% for the second year and 3¾% for the third year. Almost all of this Treasury Bill issue, and the subsequent issue of LL35 million, was taken up by the foreign banks. It is generally believed that the Treasury Bill issue was aimed largely at the foreign banks, who, at that time, did not hold much local short money.[21] One consequence of this is that local banks do not hold any paper which is eligible for rediscounting by the Central Bank.

With such low interest rates on Treasury Bills it will be at once apparent that the inter-bank market cannot be profitable, especially as interest rates of up to 5% may be obtained on some classes of demand deposits in some Lebanese banks. If the short-term money market is in need of more government debt to make it more viable, then this debt will have to be offered at an interest rate, which is realistic, in terms of rates obtaining elsewhere. Otherwise increasing government debt will merely stifle the market.

In the absence of any substantial amount of short term government debt, and in the absence of a high-earning capacity call money market, most Lebanese banks are forced

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21. The foreign banks were "encouraged" to participate, which explains why the issue was fully taken up at these low rates of interest.

to hold a high proportion of their assets in liquid form to maintain confidence, and this reduces their earning capacity on the rest of their assets. In addition the system described here tends to discriminate between indigenous banks and foreign banks. In times of crisis the foreign banks can strengthen their liquid reserves either by drawing on their foreign currency assets (mostly held in the form of Euro-dollar bonds), or by asking their head office abroad for reinforcements. Indigenous banks do not hold as high a proportion of foreign currency assets, and do not have the opportunity to call on overseas reserves. Nor do many indigenous banks hold any discountable paper, which they could rediscount through the Central Bank. The net effect is that the indigenous banks have to appeal directly to the Central Bank for a loan, if they become illiquid at any time. This is something that has heppened increasingly since 1966.

Thus the levels of liquidity in the banking system appear to have two major effects. Firstly, the absence of specific reserve ratio requirements and a reasonable volume of government debt at realistic discount rates, tend to favour the foreign banks, who are less dependent on local conditions. Secondly, the system that has been described tends to require a high level of liquidity from each bank, which has the effect of reducing the potential earning capacity on advances - again the foreign banks benefit

here, as they tend to hold more foreign currency deposits than local banks and can, hence, benefit from the higher interest rates in European markets without incurring any exchange risk cost.

In addition two factors need looking at in more detail. The structure of deposits is also a relevant variable in determining liquidity requirements and the distribution of advances is conditioned by these same liquidity constraints. It is these two issues which are taken up in the next chapter.

C H A P T E R S E V E N

The Structure of Deposits and Advances

The previous chapter demonstrated that liquidity in the banking system is partially determined by the structure of deposits. In addition the high levels of liquidity observed in the banking system will influence the structure of advances. The argument was developed in the first chapter that if depositors in general use the banking system as a short-term facility then this will inhibit growth in long-term markets, and may ultimately influence the rate of economic development. This general theoretical point can now be studied in more detail by analysing the structure of deposits and advances in Lebanon.

The main component in the structure of total deposits is savings deposits. In Lebanon these are defined as those deposits which are redeemable on demand but on which no cheques can be drawn. This type of deposit is very popular since interest is normally paid on the outstanding balance and many commercial transactions are still executed in cash making the penalty of not being able to draw cheques on the account a slight one. Normally the rate of interest on

savings deposits (the interest is tax free) is higher than that on demand deposits. The rates on savings deposits have varied quite considerably over the last decade. By mid-1974 savings accounts in Lebanese pounds were earning 6-7%, whilst savings accounts in major foreign currencies (predominantly dollars) were earning 9-10%. Again, this differential in earnings rates reflects the exchange risk premium on converting Lebanese pound deposits to foreign currencies, to take advantage of money market rates in other countries.

If we define demand deposits as consisting of "checking" and "current" accounts (the distinction in Lebanon between these two is simply that current accounts represent 'professional deposits fed generally by remittances of bills' whilst checking accounts represent 'accounts of individuals, accounts that are generally fed by remittances of funds)[1] and add these to savings deposits, then we can get an idea of the total volume of funds which can be withdrawn on demand, i.e., without prior notice. Table 7.1 shows that for the period 1964-1973 savings and demand deposits have averaged over 85% of total deposits, in every year. What is more interesting is that this percentage has gradually been rising throughout the period. This is demonstrated in Table 7.2.

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1. The definitions come from Statistiques Bancaire, Instruction No. 1-62, published by the Lebanese Ministry of Finance.

Table 7.1: Commercial Bank Deposits (in LL million)

Year Qtr.	Savings	Checking	Current	Time Deposits	Total Deposits
1964					
I	571	618	661	427	2,277
II	635	619	643	404	2,301
III	735	636	612	401	2,384
IV	835	641	645	388	2,509
1965					
I	955	665	660	326	2,606
II	1,037	671	641	377	2,726
III	1,167	665	633	379	2,844
IV	1,255	668	675	444	3,042
1966					
I	1,393	672	591	405	3,061
II	1,554	707	606	400	3,267
III	1,719	699	602	433	3,453
IV	1,485	548	587	317	2,927
1967					
I	1,491	531	558	314	2,894
II	1,381	474	554	301	2,710
III	1,389	491	572	337	2,789
IV	1,422	483	544	276	2,725
1968					
I	1,506	487	559	283	2,835
II	1,514	511	629	288	2,942
III	1,626	540	624	301	3,091
IV	1,698	544	623	269	3,134
1969					
I	1,719	548	621	298	3,186
II	1,922	564	625	145	3,256
III	2,004	537	604	136	3,281
IV	2,088	510	573	143	3,314

continued over. . .

Table 7.1 (continued)

Year Qtr.	Savings	Checking	Current	Time Deposits	Total Deposits
1970					
I	2,252	496	554	139	3,441
II	2,385	515	570	146	3,616
III	2,481	508	583	139	3,711
IV	2,699	515	616	161	3,991
1971					
I	2,898	545	623	156	4,222
II	3,118	570	671	177	4,536
III	3,258	582	713	193	4,746
IV	3,454	637	718	191	5,000
1972					
I	3,663	679	747	215	5,304
II	3,928	668	821	105	5,522
III	4,110	681	826	167	5,784
IV	4,295	750	828	177	6,150
1973					
I	4,451	855	876	204	6,386
II	4,532	789	859	207	6,387
III	4,782	815	920	241	6,758
IV	5,063	837	1,045	295	7,240
1974					
I	5,470	909	1,147	293	7,819

Source: Bulletin Statistique Mensuel, Ministere du Plan, Direction Centrale de la Statistique.

Table 7.2: Demand deposits and savings deposits as a percentage of total deposits 1964-1973

Year	Percentage
1964	85.8
1965	86.4
1966	87.7
1967	88.9
1968	90.5
1969	94.5
1970	96.0
1971	96.2
1972	97.0
1973	96.5

Source: Bulletin Statistique Mensuel. N.B. the quarterly figures have been added and divided by four to obtain an average for the year.

The fact that an increasing proportion of total deposits are technically on demand is not necessarily a serious situation for an individual bank. Indeed if savings deposits are used as a means of financing predictable and discrete purchases then the demands put upon these deposits can be predicted fairly accurately. Sayers emphasises the distinction that needs to be made between current and deposit accounts in the United Kingdom and in doing so provides general evidence which is useful in the present context. Sayers argues that when an individual

customer switches funds from a current account to a deposit or savings account he is effectively making a decision about forgoing consumption and is, therefore, ultimately going to influence aggregate levels of output and employment. The switch from one type of account to another has not altered the financial system in terms of its total liabilities,

> ". . . but the effectiveness of this total in generating and supporting the flow of income is reduced by the action of saving".[2]

Here Sayers is stressing the fact that current accounts and savings accounts are to be seen as entirely different repositories of money: the former concerned with short-run expenditure decisions, the latter with longer-term expenditure decisions. This is true by convention, rather than rule, in the United Kingdom. In Lebanon no such clear distinction between types of account is made. Savings deposits appear to be treated in every respect as demand deposits, that is apart from being able to draw cheques on the deposits. The obvious implication of this is that if such a high percentage of deposits are withdrawable on demand then liquidity ratios, of necessity, are going to be at a high level and consequently banks will find that a high proportion of their loans are

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2. R.S. Sayers, Modern Banking, 6th edition, (London: Oxford University Press 1964), p.229.

short-term in nature, thus reducing the ability of any bank to lend long.

It could be argued in contradiction to this that individuals will attempt to minimise their cash holdings subject to the constraint that all present expenditures can be met (this is extending the ideas of Patinkin developed in Chapter One.) If this is so then it does not really matter how deposits are held since only a certain proportion will normally be withdrawn from the system. The word normally is emphasised here, since it seems to be assumed that the notion of a minimum cash balance refers to discrete and predictable expenditure patterns. However, it could be argued in the Lebanese case that sufficient uncertainty has been generated over the last decade for individuals to wish to increase their potential cash balances by holding easily-redeemable deposits in the banking system. In other words, the preference for savings accounts over say, time deposits, represents some sort of precautionary demand for money.

A further investigation of Table 7.1 bears out the points made above. Since 1964 savings deposits have expanded at a relatively faster rate than all other deposits. If interest earned on accounts was responsible for this growth, then one would expect a corresponding increase in time deposits, where the interest rates are normally higher than savings deposits. No such increase

is observable suggesting that whilst a rate of return on a deposit is desirable the liquidity of the deposit is the most significant factor. It seems therefore that the immediate redeemability of the savings deposits (plus its earning capacity) is crucial in a banking system which has witnessed a number of bank closures over the last eight years. Thus the crucial characteristic of deposits in Lebanon, as far as the depositor is concerned, is the ease with which the deposit can be redeemed. This characteristic appears to predominate over any interest rate advantages offered by time deposits.

An additional complicating factor which affects all deposits is that deposits may be denominated in foreign currencies. The fact that foreign currency deposits have been accepted by Lebanese banks for many years and also that the Banking Secrecy Law has provided anonymity has meant that foreign currency deposits have always been an important constituent of total deposits. Separate data for foreign currency deposits is not available, although separate figures were issued from 1955 to 1962. However, estimates of total foreign currency deposits and time deposits are provided by the I.M.F. in their International Financial Statistics. The problem is to abstract the domestic time deposits element from this total; to achieve a figure for foreign currency deposits along (including time deposits denominated in foreign

currencies). The figures for time deposits provided by the Central Bank include foreign currency time deposits and, therefore, in this case, a method is needed to abstract the foreign time deposit element. If we take the time deposit figures for 1962, i.e. the last year when separate figures for foreign currency deposits were issued, we can see that foreign currency time deposits represented nearly 43% of total time deposits.[3] If we assume that the ratio of foreign currency time deposits to domestic time deposits has remained approximately constant since 1962, then the figures for total time deposits can be reduced by approximately 40%, to give an estimate of domestic currency time deposits. If this estimate is taken away from the aggregate figure for foreign currency and time deposits provided by International Financial Statistics, then a figure for foreign currency deposits alone is obtained. These figures are reproduced in Table 7.3. This rather complicated procedure for obtaining a figure for foreign currency deposits can be justified, from a technical point of view, on the grounds that the time deposit element in total foreign currency deposits is not large and even if the ratio of domestic to foreign currency deposits has changed fairly dramatically

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3. The figure for total time deposits is taken from International Financial Statistics and the one for foreign currency time deposits from Banque de Syrie et du Liban, Rapport 1963.

Table 7.3: Foreign Currency Deposits 1964-1974
(millions Lebanese pounds).

1964		1969	
I	n.a.	I	1641
II	807	II	1833
III	927	III	1896
IV	1038	IV	1976
1965		1970	
I	1194	I	2068
II	1217	II	2160
III	1344	III	2286
IV	1539	IV	2493
1966		1971	
I	1553	I	2632
II	1758	II	2849
III	1915	III	3095
IV	1695	IV	3246
1967		1972	
I	1679	I	3347
II	1568	II	3634
III	1589	III	3823
IV	1618	IV	3999
1968		1973	
I	1696	I	4269
II	1790	II	4305
III	1862	III	4598
IV	1560	IV	4935
		1974	
		I	5350

Source: International Financial Statistics, with the procedures for abstracting domestic time deposits described in the text.

since 1962, this would not alter, substantially, the figures produced in Table 7.3.

The presence of foreign currency deposits in the deposit structure of the Lebanese banks adds another dimension to this structure. Foreign currency deposits are important, firstly because of the considerable entrepot trade through Beirut which often requires direct financing in a currency other than Lebanese pounds and, secondly, because Beirut has become in some senses a financial centre of the Middle East. If total deposits are compared with foreign currency deposits this will give some indication of the importance of the latter. The ratio between the two is set out in Table 7.4. The most noticable feature is that during the period 1964-1973 foreign currency deposits have gradually become a more important element in total deposits. The share of foreign currency deposits in total deposits has risen from 35% at the beginning of 1964 to 68% by the end of 1973. The one period when foreign currency deposits suffered a set-back was at the end of 1968 and during 1969. This was largely due to an order from the Central Bank to all commercial banks to deposit 5% of their total deposits in the Central Bank in local currency. This forced many banks to move out of foreign currencies into Lebanese pounds. However, barring this short reverse there has been a gradual upward trend. There are two points that

Table 7.4: Total Bank Deposits and Foreign Currency Deposits 1964-1973

	(1) Total Deposits	(2) Foreign Currency Deposits	Col. (2) as a % of Col. (1)
1964			
I	2277	n.a.	-
II	2301	807	35.07
III	2384	927	38.8
IV	2509	1038	41.4
1965			
I	2606	1194	45.8
II	2726	1217	44.6
III	2844	1344	47.2
IV	3042	1539	50.5
1966			
I	3061	1553	50.7
II	3267	1758	53.8
III	3453	1915	55.4
IV	2927	1695	57.9
1967			
I	2894	1679	58.0
II	2710	1568	57.8
III	2789	1589	57.0
IV	2725	1618	59.3
1968			
I	2835	1696	59.8
II	2942	1790	60.8
III	3091	1862	60.2
IV	3134	1560	49.7
1969			
I	3186	1641	51.5
II	3256	1833	56.3
III	3281	1896	57.8
IV	3314	1976	59.6

continued over . . .

Table 7.4 (continued)

	(1) Total Deposits	(2) Foreign Currency Deposits	Co. (2) as a % of Col. (1)
1970			
I	3441	2068	60.1
II	3616	2168	60.0
III	3711	2286	61.6
IV	3991	2493	62.5
1971			
I	4222	2632	62.3
II	4536	2849	62.8
III	4746	3095	65.2
IV	5000	3246	65.0
1972			
I	5304	3347	63.1
II	5522	3634	65.8
III	5784	3823	66.0
IV	6150	3999	65.0
1973			
I	6386	4269	66.8
II	6387	4305	67.4
III	6758	4598	68.0
IV	7240	4935	68.2
1974			
I	7819	5350	68.4

Sources: As for Tables 7.1 and 7.2.

can be made about this trend. Firstly, the trend shows that as total deposits have expanded a lower relative volume of local currency deposits are entering the system. The expansion in total deposits appears to be largely due to the foreign currency element. This is to be expected since Beirut has become a centre for short-term deposits especially from the Gulf oil states. In countries such as Kuwait, Bahrain, Abu Dhabi and Qatar there are very limited opportunities for direct investment and, therefore, local deposits tend to be channelled abroad by the commercial banks into such centres as Beirut.[4] As we have already seen, Beirut also has the attraction of providing complete anonymity for its depositors under the Banking Secrecy Law of 1956. However the second point that has to be made is that whilst total deposits are expanding, because of increasing foreign currency deposits, the expansion of local deposits has been very slight. This means that the amount of borrowing on local currency deposits has not expanded at the same rate as total deposits. In general terms this means that total deposits, in the Lebanese economy, are not necessarily a good indicator of the potential expansion of advances to the domestic economy.

Apart from foreign currency deposits consideration

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4. This net outflow of funds from the Gulf is commented on specifically in Kuwait Currency Board; Sixth Annual Report, 1967.

must be given to deposits in local currency held by non-Lebanese. These deposits may represent temporary trading balances held by foreign merchants in Lebanon or the balances of expatriates living in Lebanon. The fundamental problem of these sorts of deposits is that the commercial banks as a whole are under no obligation to hold foreign currency assets against these deposits. Indeed it would be extremely difficult for the banks to assess the volume of foreign currency reserves necessary to cover withdrawals of these deposits (this is assuming that the withdrawal ultimately requires the bank to redeem the deposit in the currency of the country of the depositor). Ultimately the Central Bank will feel a drain on its foreign assets if there is a rapid repatriation of this type of deposit over a short period of time. This drain on Central Bank reserves may ultimately affect the balance of payments. The extent to which these affects are possible is dependent on the size of these deposits in total deposits. Unfortunately, no figures for local currency deposits held by non-Lebanese exist.

From the point of view of the arguments already presented in this chapter, local currency deposits held by non-Lebanese will tend to restrict the volume of local lending still more. If these deposits are ultimately redeemable on demand in currencies other than Lebanese

pounds, then the banks are virtually forced into the position of acquiring short-term assets in foreign currencies, rather than lending locally. Thus an estimate of total deposits in local currencies held by local depositers is necessary to establish the extent of internal lending by the banking system. The Bank of Lebanon has estimated in a number of its annual reports that total deposits held by non-residents does not exceed about 15%. Assuming the majority of non-resident accounts are held in foreign currencies this means that non-Lebanese local currency deposits probably do not exceed 5% of total deposits. Bearing this "guesstimate" in mind, we can now see that about 27% of total deposits are local currency deposits held by residents.[5]

Classifying deposits by deposit holders and by type of currency is important to our analysis. When describing the rate at which credit can be expanded it is conventional to look at the total volume of deposits, then calculate a bank multiplier based on certain assumptions about cash and liquidity reserve requirements. Thus if it is necessary for an individual bank to maintain a given cash reserve, total deposits (X) will be related to the bank's cash deposits (C) in the following manner:

$$X = \alpha C \qquad (1)$$

where α = the reciprocal of the cash ratio.

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5. This figure is derived from the 68% of total deposits held in foreign currencies, plus the 5% held by non-Lebanese in local currency.

The term α can also be used to denote a general liquidity requirement. If there is an increase in cash deposits and the public's preference for cash remains constant, then expression (1) will determine the extent to which deposits may be expanded in relation to the given liquidity requirement. More specifically the incremental gain can be specified as:

$$\Delta X = \alpha \Delta C \qquad (2)$$

For a multi-bank system the expansion of total deposits is given as:

$$\Delta X = C + (1 - \tfrac{1}{\alpha})\Delta C + (1 - \tfrac{1}{\alpha})^2 \Delta C \ldots (1 - \tfrac{1}{\alpha})^n \Delta C \qquad (3)$$

which in the limit approaches equation (2). This is the convential way in which the bank multiplier is often analysed.[6] The implication of this analysis is that all money not held as a liquidity reserve is available for loaning. In addition it is implicit here that we are dealing with a single currency. Neither of these two points apply in Lebanon. Deposits are denominated in numerous currencies and it is not possible to assume that banks loan all cash deposits in excess of basic liquidity requirements. Even if all deposits were in local currencies, this does not imply that the system will be fully loaned. The extent to which new deposits are created will be dependent on (a) viable outlets for new deposits, and

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6. The analysis presented here follows that presented in W.T. Newlyn, Theory of Money, (London: Oxford University Press 1965), pp.13-16.

(b) the rate of return on alternative assets. We will return to the first point later in this chapter. The second point is important in the Lebanese case since there are considerable opportunities for investment in short-term assets in overseas money market. The obvious objection to this point is that there is always a risk of capital loss through currency appreciation if deposits are converted into foreign currencies. This is always likely in Lebanon where the currency has operated on a free market since 1949. However the majority of deposits are denominated in foreign currencies in the first place and, therefore, the currency risk works the other way round. There is a greater gain to be had from investing in dollar and sterling markets, than converting dollar and sterling deposits into Lebanese pounds and creating loans internally. The gain is twofold. In the first place there is no chance of capital loss through fluctuations in the exchange rate and secondly the assets acquired in overseas markets tend to be short term, whereas internal loans may be longer-term and have a higher risk premium attached to them. In addition the evidence available from 1960-1974 suggests that the earning rate on overseas assets has been higher than that on internal loans. This has largely been due to the high interest-rate levels in European money markets, especially the Eurodollar market. Bearing these points in mind we can return to the analysis of the simple bank multiplier presented

earlier. Total deposits consist of local currency deposits (X_L) and foreign currency deposits (X_F). In addition local currency deposits and foreign currency deposits may be held by both residents and non-residents. It is very difficult to assess to what extent the ownership of a deposit can influence its behaviour. Therefore, we will assume initially that the ownership of deposits does not influence the way a bank distributes its portfolio. The liquidity ratio cannot be specified for the system as a whole, since no legal requirements are specified by the Central Bank. However, each bank has a subjective view of what level of liquidity is necessary at any one time. This subjective view of liquidity may in fact be different for foreign currency deposits than for local currency deposits. Let us assume a bank holds 50% foreign currency deposits and 50% local deposits. If the bank only creates advances on the local deposit element then the foreign currency element will be entirely covered by short-term foreign assets, i.e. there will complete liquidity in one element of the deposits. This means that, at the very least, two separate liquidity ratios need to be specified for the single bank. Thus:

$$X = X_L + X_F \qquad (4)$$

and defining the relationships between total deposits and cash holdings we have,

$$X = \alpha^1 X_L + \alpha^2 X_F \qquad (5)$$

where α^1 and α^2 are reciprocals of the liquidity ratios for local deposits and foreign currency deposits. However we can assume that foreign currency deposits (X_F) are fully liquid in that no domestic credit expansion takes place on the basis of them, so equation (5) could read as follows:

$$X = \alpha^1 X_L + X_F \qquad (6)$$

The total expansion in deposits for the single bank is defined as:

$$\Delta X = \alpha^1 \Delta X_L + \Delta X_F \qquad (7)$$

For a multi-bank system the problem becomes more difficult. If α^1 and α^2 are partially subjective ratios, then they will only apply to one bank and, therefore, the actual expansion of deposits may depend crucially on the order in which the banks are influenced. However, returning to equation (7), two important points emerge. The total volume of domestic credit available to the economy is going to depend firstly on the relative sizes of domestic and foreign currency deposits in any one bank's portfolio, and secondly on the subjective liquidity ratios applied to each set of deposits. If α^2 takes a value of 100% then an increase in foreign currency deposits, relatively, will <u>reduce</u> the total volume of domestic credit, unless banks respond by lowering the liquidity requirement (α^1) on domestic currency deposits. From Table 7.4 it can be seen that this ratio between total deposits and foreign currency deposits has indeed been rising over the last decade, which suggests

that the impact of the tripling of total deposits from 1964 to 1973, noted in Table 7.1, has probably had very little effect on the total availability of medium-term credit in the domestic economy.

However, the pattern of advances tends to illustrate a slightly more complicated picture than this.

Advances

Data is presented in Tables 7.5 and 7.6 on the total volume of advances on an annual basis since 1966 and a sectoral breakdown of these advances from the same year. This sectoral breakdown was provided by the Central Bank for the first time in 1964.[7] Estimates were prepared prior to 1964 by the American Embassy in Beirut but the classifications used do not make it easy to link the two series. In fact, the first figures prepared by the Central Bank were not consistent and the breakdown shown in Table 7.6 can only, reasonably, be extended back to 1966. The traditional financing of overseas and domestic commercial activity is very obvious from the figures presented in Table 7.6. In no year since 1966 have commercial loans dropped below 53% and toward the end of the period under study were rising to a total of nearly 60%. The decline

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7. Banque du Liban, Rapport Annuel 1964.

Table 7.5: Total Deposits and Advances 1966-1973

	(1) Total Deposits	(2) Total Advances	Col.(2) as a % of Col. (1)
1966	2927	2293.2	78
1967	2725	2257.1	83
1968	3134	2018.1	64
1969	3314	2027.4	61
1970	3991	2084.1	52
1971	5000	2613.7	52
1972	6150	3216.3	52
1973	6387	3678.1	57

Sources: As for Table 7.1 and Banque du Liban, Rapport Annuel

in the ratio of advances to deposits noted in Table 7.5 indicates two things. Firstly, it points to the extremely illiquid situation that existed in 1966 and 1967 that led to the considerable changes in the financial sector in 1968, and secondly points to the increasing volume of foreign currency deposits in the system, especially since 1969. For instance the 100% increase in foreign currency deposits between the beginning of 1969 and end of 1971 was matched only by a 56% increase in total deposits, or, more to the point, a 13% increase in domestic currency deposits.

Despite the increasing predominance of foreign currency

Table 7.6: Classification of Loans by Economic Sectors 1966-1973 (in millions of Lebanese pounds)

Sector	1966	1967	1968	1969	1970	1971	1972	1973
Agriculture	92.9	94.4	88.3	92.9	82.8	85.8	122.9	160.4
Industry	290.7	333.3	337.9	326.6	345.2	435.9	512.6	760.2
Construction	195.5	212.7	212.1	222.7	242.9	291.3	368.5	545.1
Commerce	1246.6	1240.4	1106.2	1112.3	1214.5	1401.6	1738.0	2380.2
Financial Institutions	143.0	134.6	79.1	84.3	70.0	89.1	171.1	278.9
Others	328.3	241.5	194.5	218.6	128.7	310.0	303.2	553.3
Total	2293.2	2257.1	2018.1	2027.4	2084.1	2613.7	3216.3	3678.1

Sources: Banque du Liban, Rapport Annuel.
Association des Banques du Liban, Rapport Annuel.

deposits and the major emphasis on commercial loans, an interesting feature of Table 7.6 is that advances to the industrial sector have been gradually rising relatively, since 1966. In 1966, 12.6% of all advances went to the industrial sector, whereas 20.6% of all advances was allocated to industry in 1973. One major explanation for this move has been the increasing optimism felt about the development of the Lebanese economy. The uncertainties in the financial sector in 1966, plus the continuing conflicts with Israel into which Lebanon was inevitably drawn, if not directly, indirectly in the sense that the continuous warfare reduced confidence in the economy. This confidence appeared to return from 1971 onwards, and this appears to have encouraged a move into industrial financing by the commercial banks. However what loans there are, are normally provided on a revolving basis and often demand considerable collateral, either real estate or personal guarantees. These factors generally conspire against innovation in the industrial sector. The revolving credit system reduces the time horizon over which industrial projects can be planned with safety and the present collateral demands are not designed to encourage new industrial enterprises.

Even though there has been an expansion in industrial advances over the last five years, there is no evidence that this expansion is spread evenly over all banks.

What general evidence that is available suggests that foreign and indigenous banks appear to have a very similar advances to total deposits ratio. However, there is no information on the distribution of those advances between sectors and between types of banks. All the evidence that is available points to the foreign banks generally adopting a conservative attitude to advances in that they concentrate on commercial loans. If this is generally true, it means that the indigenous banks are mainly responsible for the relatively faster growth of industrial advances. But has this expansion into industrial finance been achieved at the expense of liquidity? Whilst the Central Bank continues not to have complete control over liquidity ratios, the local banks can become more illiquid without incurring the direct displeasure of the Central Bank. The evidence for this type of assertion is not readily available, but what data there is seems to point in this direction. Since 1970 the Association of Banks in Lebanon have published standardized balance sheets for all "approved" banks. If the top nine indigenous banks (accounting for 65% of deposits amongst the local banks) are compared in terms of their liquidity ratios for 1970 and 1972, then they experienced a decline in liquidity from 47.6% of total assets in 1970 to 44.0% of total assets in 1972. At the same time the foreign banks and joint-participation banks decreased their liquidity

from approximately 59% of total assets to 54% of total assets.[8] Thus the whole system became less liquid but the absolute fall in liquidity amongst local banks has been greater, suggesting that they have been an important element in the extension of industrial loans in this period.

The changing structure of deposits and advances are presented in Table 7.7. This table initially gives a misleading picture, since the total growth in deposits attributable to foreign banks is the lowest of the three categories employed in the table.

However, as Central Bank legislation since 1970 has made the establishment of new foreign banks difficult, but the establishment of joint ventures easy (see Chapter Eight), the growth in "foreign banking" has occurred in the joint participation sector. Again Table 7.7 shows a rapid rise in advances. This would seem to lend support to the earlier assertion that the most rapid growth in advances is occurring in the foreign sector.

To summarise this discussion on advances some mention needs to be made of interest rates on advances. From the beginning of 1974 commercial loan rates on medium-term loans have varied between 8% and 12%, although from April

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8. Association of Banks in Lebanon, Balance Sheets of the Banks 1970 and 1972, (Beirut: Imprimerie Catholique 1970 and 1972).

Table 7.7: The Growth of Deposits and Advances 1970-1973 by Bank Types

	1970		1971		1972		1973	
	Deposits	Advances	Deposits	Advances	Deposits	Advances	Deposits	Advances
Foreign banks	2071	919	2185	1001	2399	1276	2977	1288
Participation banks	1020	581	1538	781	1988	1078	2464	1546
Indigenous banks	899	510	1276	684	1824	926	2318	1368

Source: Association of Banks in Lebanon, Banks' Balance Sheets 1970-1973, (Beirut: Imprimerie Catholique).

Notes: 1) The deposit totals for 1972 and 1973 do not correspond directly with the totals in Table 7.1 as the Association of Banks include a number of small "finance banks" not on the approved list.

1974 special rates of 8.5% and 9.5% have applied to specific industrial and tourist projects negotiated through the new National Bank for Industrial and Touristic Development. As this particular bank is constrained in its lending operations by its capital (since it does not, yet, accept deposits from the public), it is unlikely that these lower rates will have a significant impact on the other commercial banks. Short-term loans tend to be offered at 9-10%.[9]

Two factors seem to emerge from the discussions in this chapter. Firstly, since 1966, there has been a rapid rise in total deposits, such that by mid-1974 total deposits in the banking sector had more than doubled since 1966. Secondly, there has been an even more rapid increase in foreign currency deposits. This means that the growth of local currency deposits has been slower than the rate of growth of total deposits. At the same time advances to the domestic economy have grown in line with total deposits, implying either that some domestic credit expansion is backed by foreign currency deposits or that local banks, in particular, are becoming more illiquid as they respond to the demand for advances in the domestic market.

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9. Information on interest rates was privately secured.

This chapter has also emphasised the role that the Central Bank might play in expanding domestic credit. We now need to turn to look in more detail at the role of monetary control within the financial sector.

C H A P T E R E I G H T

Monetary Control and the Financial Sector

This chapter examines the roles of the Central Bank in relation to the financial sector in the period since the establishment of the Central Bank in 1964. It will be argued in this chapter that the powers granted to the Central Bank have never been fully exercised and that consequently this has adversely affected the development of the financial sector.

The Monetary and Credit Act of 1964 laid down the conditions under which the new Central Bank of Lebanon would operate.[1] The main mission of the new Central Bank was to safeguard the monetary system in order to provide a basis for long lasting economic and social progress (Article 70). In its general form the Central Bank of Lebanon varies little from many other central banks in developing countries. It is run by a Governor, three Deputy Governors and a Central Council.

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1. The Monetary and Credit Act, Decree No. 13513 (The Official Gazette No. 62 August 8th, 1962) - English translation by M.H. Salloum.

The Governor and the Deputy Governors are appointed by the Minister of Finance and serve for six- and five-year periods respectively (Article 18). The Central Council decides the general policy of the Bank. This Council consists of the Governor, two deputy governors and the directors-general of the Ministry of Finance and the Ministry of National Economy (Article 28). The Central Council is also assisted by a Consultative Committee whose membership is drawn from various sectors of the economy.

The functions of the Central Bank, as laid down in the Monetary and Credit Act are those normally associated with Central Banks: (i) sole note issuer; (ii) government banker; (iii) banker to the commercial banks, and (iv) the sole authority for intervention in foreign exchange markets. In addition the Monetary and Credit Act defined more precisely the "proper" business of commercial banks. New regulations came into force in the Act restricting banks activities in real estate investments (Article 153); the granting of loans to Directors of the bank concerned (Article 152) and the regularization of procedures for granting loans. The Central Bank of Lebanon, in 1964, began its operations in a financial system which up to that date had been totally unregulated. However, the broad range of issues covered by the Monetary and Credit Act do seem to suggest that

considerable concern was already being felt about what the effects of the continuance of an unregulated system might be.

There has been considerable discussion in economic literature on the desirability of establishing central banks in developing banking systems. As Sayers has commented,

> "Looking back it is impossible to resist the statement that the foundation of central banks has been partly a matter of fashion . . ."[2]

This desire for central banks in many developing countries was explained by Newlyn and Rowan in the following terms. It derives from,

> ". . . the close association that existed in the minds of many individuals between the desire for political independence on the one hand and financial independence on the other. It is not surprising therefore that colonies which attain the status of Dominions are usually not slow to establish central banks and that those territories which know themselves to be approaching dominion status should give birth to proposals to create central bank institutions . . ."[3]

Whilst Lebanon in 1963 was not emerging into some independent political status, it is obviously relevant to ask whether the establishment of a central bank at that time was an appropriate action. One basic criticism of new central banks is that they are often expected to either

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2. R.S. Sayers (editor) Banking in the British Commonwealth, (London: Oxford University Press 1952) p.xi.

3. W.T. Newlyn and D.C. Rowan, Money and Banking in Colonial Africa, (London: Oxford University Press 1954) p.267.

operate in an unsophisticated financial environment or they are expected to create the appropriate environment for themselves. This partly stems from a particular concept of central bank activity derived from experiences in Europe and America. An interesting case in point are the arguments put forward by Newlyn and Rowan in the case of Nigeria. In considering the case for a central bank, Newlyn and Rowan conclude,

> ". . . The view that a central bank can promote economic stability by monetary management is, to put matters tersely, nothing but an illusion . . ."[4]

The main reasons for this conclusion were: (i) the considerable dependence of the Nigerian economy on external destabilizing forces, (ii) the generally underdeveloped nature of the banking and financial system. Yet the case for a central bank is not altogether discarded by Newlyn and Rowan. Their argument for a central bank is instead based on the need for an institution with the responsibility for fostering economic development,

> ". . . The case for establishing a central bank thus rests on the contribution such an institution might make to economic development . . ."[5]

They argue further,

> ". . . that the central banking contribution would be greatest where the particular tasks of reform were

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4. W.T. Newlyn and D.C. Rowan, op. cit., p.271.
5. Ibid., p.271.

> the development of the indigenous banks, the integration of the expatriate and indigenous banks, the development of a local securities market and the development of agricultural credit . . ."[6]

Thus central banking, here, is seen more in terms of the control the monetary authorities might have over the growth and development of financial institutions within the financial sector and the disbursement of total financial resources over time. This type of point is emphasised by Patrick when he says,

> ". . . The monetary authorities have an important institution-building role in encouraging the establishment of a wide array of financial markets (and financial institutions to operate in these markets) which allocate saving competitively to the most productive investors. One important approach is . . . . by clearing away impeding institutional and other obstacles of a legal or customary nature. The financial authorities can create an environment which is conducive to growth both of the real economy and of the financial system . . ."[7]

Bearing in mind these rather conflicting views on the roles of a central bank, then assessment of performance becomes increasingly difficult. One way out would be to take the view expressed by Nevin,

> ". . . For the underdeveloped territories of the world the usefulness or otherwise of a central bank must therefore be assessed first and foremost in terms of its ability to assist the process of economic growth and capital formation; the contribution it can make to the regulation, direction and guidance of such credit institutions as may exist at the time must be a secondary and lesser consideration . . ."[8]

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6. Ibid, p.272.

7. H.T. Patrick, "Financial Development and Economic Growth in Underdeveloped Countries", Economic Development and Cultural Change, Vol. 14, No. 1, January 1966, p.186.

8. E. Nevin, Capital Funds in Underdeveloped Countries, (London: Macmillan and Co. Ltd., 1961) p.24.

However this view of Nevin's seems to have a basic fault in it. It seems to assume that the promotion of growth and capital formation is somehow independent of the control and regulation of credit institutions. It has been one of the contentions of this thesis that the structure of the financial sector of the financial instruments generated by that sector can affect directly events in the real sector and hence central bank control cannot be said to be more important in one respect than the other when the two are inter-dependent. Perhaps a more pragmatic view is the one expressed by Asseily in analysing whether a Central Bank was required in Lebanon. He argues finally that in terms of the traditional functions of a central bank, the new Central Bank in Lebanon had no more power than the already established Banque de Syrie et du Liban (BSL). However, the main benefit of the creation of the Central Bank must be seen in the fact that for the first time a financial infrastructure was clearly defined, which in the future would have the power to assist in the financing of economic development of the country.[9] Asseily came to these conclusions almost as soon as the Central Bank was created. Ten years on more emphasis can now be placed on the second aspect of his conclusions.

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9. A.E. Asseily, Central Banking in Lebanon, (Beirut: Khayat Book and Publishing Co. 1967), especially Chapter Five.

There do not appear to be any unique set of criteria by which to judge the performance of a central bank. Most writers when discussing the roles of central banks in developing economies appear to conclude that there are at least two roles: (i) developmental and (ii) regulatory. We are of the view that these roles cannot be separated entirely and, therefore, it is not appropriate to judge the central bank as an agency for assisting in the financing of economic development, independently of its role as a regulator of the financial system. Quite clearly a central bank through the issue of new financial instruments can expand the total volume of financial resources, but equally financial resources can be increased in a regulatory fashion if the central bank introduces new legal conditions which are conducive to financial growth. Bearing these basic points in mind, we are in a position to analyse more precisely the influences that the Central Bank of Lebanon has had on the financial sector since 1964.

The problems faced by the new Central Bank were numerous, but probably the most obvious was the unregulated growth of the banking sector since the mid 1950's. The Banking Secrecy Law, coupled with a minimum of restrictions on the development of financial institutions resulted in a rapid growth of banking institutions in Lebanon, as noted in Chapter Five.

> ". . . In the narrow credit market of Lebanon this tended to produce an undue measure of competition, to strain the profit prospects of many banks, and, in the absence of control, to steer some of them into unhealthy investment policies and practices. The acute competition and the supremacy of the foreign and foreign-controlled banks prevented a number of banks - too small to be viable - from growing. The supply of qualified managers, especially at the top levels, failed to keep pace with the rapid increase in the number of banks. As a result, the quality of management among the newly-emerging banks inevitably deteriorated . . ."[10]

Given this situation, how can the system be regulated. One obvious point would be to impose reserve requirements on all banks, as the Central Bank had the power to do under Article 175 of the Monetary and Credit Act. However there were two immediate drawbacks to this type of regulation. Firstly it was recognized that the foreign banks were dominant in the banking sector and that a specific reserve ratio requirements would affect, adversely, the smaller local banks rather than the larger foreign banks, since it was known that the foreign banks tended to have a more liquid total assets portfolio anyhow. Thus specific reserve ratios might have the affect of squeezing out small indigenous banks, and it was the Central Bank's belief at that time that the small indigenous banks were in need of protection rather than destruction. Secondly, the stipulations of the Banking Secrecy Law made it

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10. S.A. Hoss, "The (Lebanese) Banking System since 1966", The Banker, January 1972, p.66.

extremely difficult for the Central Bank to obtain accurate information on the total assets structure of the banking sector. Prior to the establishment of the Central Bank, the Association of Banks in Lebanon had fought bitterly with the Ministry of Finance to ensure that the Banking Secrecy Law was not violated by the new Central Bank legislation. The compromise that was reached was that a separate Banking Control Commission should be set up to act as an inspectorate of banks' assets (Articles 148-151). This compromise meant that the Central Bank could not be fully informed about the assets of the banks, since the control commission was an autonomous body within the Central Bank.[11] Thus the basic information on which reserve ratios could have been specified simply was not available. Even if the information had been available a further problem existed in that reserve ratios were to be specified on the basis of Lebanese currency deposits (Article 76), which presumably could have the effect of increasing the banks' preference for foreign currency deposits, which obviously could have some effect on the foreign exchange market as well as the generation of domestic credit. Thus on a number of scores the imposition of strict reserve ratios did not seem appropriate.

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11. A.E. Asseily, op. cit., p.16-17.

Within the Monetary and Credit Act, there were a number of articles which automatically regularized the banking system. These included new minimum capital requirements for new banks (LL3 million) and even the direct permission of the Central Bank to open a new bank (Article 128). So the Central Bank did have power to stop the proliferation of banks; but had far less power to deal, in the short-term at least, with the already established banks.

It could be argued that those who drafted the Monetary and Credit Act were not really aware of the conditions to which it was to be applied. It is certainly true that complete information on the activities of the banking sector was not available; but it could also be argued that legislators were conscious of the benefits of a laissez-faire banking system, which encouraged net capital inflows and put Beirut at the centre of the financial map in the Middle East, and did not wish to circumscribe its activities too much through legislation. As is often the case, it took a crisis for people to realize that monetary control was vital for the future prosperity of the banking system.

The Intra Crisis

By the end of 1965, Intra Bank, established in 1951,

was the largest and the fastest growing bank in Lebanon. It achieved this position through a very aggressive campaign to secure deposits and an adventurous investment policy under the guidance of its founder, Youssef Beidas. The accounts of Intra's affairs in print are now voluminous and there is no attempt here to add to the long list.[12] What we are concerned with is the impact that the Intra closure had on monetary control. During 1966 Intra found it increasingly difficult to manage its highly diversified portfolio of investments. By this period it had equity shareholdings in nine industrial concerns (6 Lebanese; 2 French and 1 English); ten banks (4 Lebanese; 3 Brazilian, 1 Nigerian, 1 Swiss and 1 in Dubai); sixteen real estate and insurance companies (4 Lebanese, 8 French, 3 Swiss and 1 English); nine tourist and communications companies (8 Lebanese, 3 English, 2 French, 2 Swiss and 1 Iraqi). In Lebanon it had a majority shareholding in Middle East Airlines, the Beirut port authority, and many companies dealing in light manufacturing, hotels, international radio communications, licensed gambling, television broadcasting, manufacturing of construction materials, heavy contracting and construction, banking, insurance, shipping and real estate. Thus on the assets side Intra

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12. In particular the comprehensive report to the Chairman of Intra Bank by Kidder, Peabody and Co. Ltd., December 1969.

had built up a very complex illiquid portfolio, which required considerable management skills to maintain its profitability. On the liabilities side Intra Bank was very active in securing deposits in the Arabian Gulf, especially from Kuwait. In order to maintain a high growth rate on deposits, interest rates on savings accounts went as high as 9%, when comparable rates in other banks were in the 3% - 6% range.[13] Thus a basic imbalance was struck between a portfolio of long-term illiquid investments and a portfolio of short-term, volatile deposits (volatile in the sense that a shift in interest rates in, say, European markets would cause large withdrawals). Given this situation it only took the smallest rumours about managerial inefficiency to cause a run on the bank and on October 14th 1966 Intra suspended its payments. Both before the crisis and immediately afterwards Intra Bank requested no assistance from the Central Bank. It is largely assumed that no requests were made simply because Beidas, as chairman of Intra, did not approve of the setting up of the Central Bank. The immediate consequences of the Intra collapse were an outflow of funds from all local banks and a net gain by foreign banks as people shifted deposits into what were considered "safer"

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13. This was one of the facts uncovered by the Kidder, Peabody investigations.

banks. Again, the amount of information available to the Central Bank on the precise degree of illiquidity in each bank was very limited and hence the amount of assistance that the Central Bank was able to give was also limited.

Temporary arrangements concerning the drawing rights of Intra depositors were established by the Central Bank and in May 1967 a package of measures were brought forward to deal with the wider-ranging long-term problems of the whole of the banking sector.[14] Two major weapons were added to the Central Bank armoury by this new legislation: the Banking Control Commission and the Higher Banking Commission. The Banking Control Commission was given the task of supervising the day to day activities of all the commercial banks and implicit in this move was that more detailed information on banking activities would have to be furnished by the banks to the Control Commission. Specifically, the Control Commission was required to regulate all banks with regard to their liquidity position; their general solvency and their compliance with existing rules and regulations governing the banking sector.[15] The Control Commission had direct access to the Higher Banking

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14. The legislation consisted of a series of amendments to the Monetary and Credit Act (Law No. 28167)

15. S. Hoss, op. cit., p.67.

Commission,[16] who had the ultimate power to reduce or increase Central Bank facilities to individual banks, to ban specific activities, to appoint a controller to an individual bank or, even, strike a bank off the list of approved banks. Looking into the future the Higher Banking Commission also had the task of consolidating the banking position over an eighteen-month period, i.e. to the end of 1968. They had the powers to suggest closures, voluntary liquidations and mergers, based on the advice of the Control Commission.

If a bank was deemed to be non-viable it could be taken over by the Higher Banking Commission and placed in the hands of the Banque de Credit Agricole, Industriel et Foncier (B.C.A.I.F.) who then liquidated all assets and paid off all liabilities on the behalf of the government. Thus B.C.A.I.F. became the recipient of ten banks in this fashion by the end of 1968.[17] Voluntary liquidation got rid of four further banks. The bank merger policy

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16. This consisted of the Governor of the Central Bank; one Deputy-Governor; the director-general of the Ministry of Finance; one member of the Control Commission (nominated by the Association of Banks in Lebanon), the President of the Deposit Insurance Organization and a judge.

17. These banks were Banque de l'Economie Arabe; the National Co-operative Bank; the International Arab Bank; Bank of Lebanon and the Middle East; Lombard Bank Lebanon; the Professional Credit Bank; Credit Hypothecaire Libanais; Banque Al-Ahli; the Union National Bank and the Banque d'Epargne. These ten banks had total assets amounting to about LL400 million on take-over.

was not successful since the major aspect of the policy; tax exemptions for merging banks, where one of the banks had a capitalisation of less than LL3 million, hardly had any affect on small banks who were not profitable or larger banks, who might have been encouraged to merge; but found no incentives in the legislation to do so. However, the legislation of May 1967 did get rid of fourteen small banks and encouraged a further two to merge. In addition the Central Bank imposed a five year ban on the establishment of new banks (which explains why joint-participation banks have become so important in the last seven years) and introduced a deposit insurance scheme.

The National Organization for Deposit Insurance

The creation of a deposit insurance system by the Central Bank was intended to attack the basic problem of lack of confidence in the banking system. The basic advantage of a deposit insurance system is that it tends to stop the "wave" effects of individual bank closures. If, through a deposit insurance scheme, an individual bank's insolvency can be prevented from affecting other banks, then confidence can be maintained in the other parts of the banking sector. Secondly, and this is important in the Lebanese context, deposit insurance schemes tend to increase the attractiveness of depositing

in local banks. It is often asserted that foreign banks secure deposits on the basis that their large foreign assets act as a sort of insurance on the deposit. If local banks are able to offer an insurance system, then this particular advantage the foreign banks may have is reduced.[18]

Deposit insurance schemes are reputed to have a number of advantages for developing banking systems. As was pointed out in India at the time of that country's acceptance of an insurance scheme,

> "Insurance of bank deposits is intended to give a measure of protection to depositors, in particular the small depositor, from the risk of loss of their savings in the event of a bank's inability to meet its liabilities. Such protection increases the confidence of depositors, reduces the occurrence of panicky withdrawals and generally contributes to the stability and orderly growth of the banking system as a whole . . . . and thereby the mobilization of the savings of the people, rich and poor . . ."[19]

So deposit insurance does not only have negative aspects to it (preventing panic) but also positive aspects to it (increasing confidence, promoting the growth of financial institutions and increasing the flexibility of monetary policy).[20] Given these advantages of deposit insurance

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18. J.A. Marlin, "Deposit Insurance in Lebanon", privately circulated paper, July 1968.

19. "Establishment of the Deposit Insurance Corporation", Reserve Bank of India Bulletin, December 1961, p.1.

20. J.A. Marlin, "Deposit Insurance Around the World", privately circulated paper, July 1968.

it is surprising that only the U.S.A., Canada and India had implemented schemes prior to the one in Lebanon. The crucial factor seems to be how extensive the insurance should be. The amendments to the Monetary and Credit Act in 1967 set up a National Organization for Deposit Insurance, owned equally by the government of Lebanon and the banks. Each bank holds a LL100,000 share in the company and pays an annual fee, computed on the basis of its total deposits. The ensuing total is then matched by a government contribution. All deposits up to a value of LL30,000 are insured under the scheme. The system is controlled by a ten-man directorate (seven from the banks, three from the government); but there are some doubts about how the banking will react to representatives of the private banks "sitting in judgement" as it were on other banks. The deposit insurance system has hardly been tested since it was established, so it is difficult to say what benefits it has had. Whilst there may have been no direct benefits, there has probably been a number of indirect benefits, primary among these being the subjective confidence felt in the banking system as a whole.

Monetary Control Since 1967

The Intra crisis of 1966 and the package of measures

in 1968 showed how weak the original Monetary and Credit Act was, which established the Central Bank. It was only when the Central Bank demonstrated to the government how weak its position was in the face of major crises like Intra, that new legislation was drafted to improve control. The monetary control that has been discussed so far has been largely of the legislative kind. Law 28/67 really contained a number of "once-and-for-all" measures designed to secure a sound base for the Lebanese banking system. We now need to go on and look more closely at the monetary control that the Central Bank has been able to exercise over the banking system on a continuing basis.

First amongst these controls are reserve ratios. The original Monetary and Credit Act gave the Central Bank power to impose liquidity ratios on the banks; but the precise assets and liabilities to be assessed in determining such ratios were never specified. Equally, with very little information available to the Central Bank prior to 1967 on the assets/liabilities structure of the banking system, the imposition of liquidity ratios was a futile task. However, in June 1969 the Central Bank required all banks to deposit 5% of their cash (in Lebanese pounds) in the Central Bank, raised to 7% in 1972.[21.]

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21. In some sense this is analogous to the special deposit scheme in the United Kingdom, although the reasons for instituting the scheme are rather different.

A further set of amendments to the Monetary and Credit Act approved in October 1973, increased the powers of the Central Bank to establish mandatory liquid reserve requirements; but so far this measure has not been acted upon. The advantages of achieving some consistent definition of liquid reserves for the banking system are many. However primary amongst them is the fact that mandatory reserve requirements, especially if each bank holds the minimum required, makes other Central Bank policies more easy to affect. If a bank holds excess liquid assets and the Central Bank attempts to decrease domestic credit through open market operations, then this policy may not have any affect on domestic credit, if the banks as a whole choose to run-down their liquid reserves. Clearly there is a limit to how often this can be done; but if total government debt instruments are limited it may be sufficient to make the restrictionary policy abortive.[22] Equally, mandatory reserve requirements would reduce the subjective view of what level of liquidity is necessary in an unregulated banking system (as demonstrated in Chapter Six) and hence would increase the potential for expanding domestic credit.

The establishment of legal reserve ratios is not an end in itself. It is a means by which a Central Bank

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22. A.B. Cramp, Monetary Management: Principles and Practice, Studies in Economics No. 6 (edited by C. Carter), (London: George Allen and Unwin Ltd., 1971) p.59.

attempts to create a more regulated financial system. In the case of Lebanon, legal reserve requirements might have the affect of discriminating between foreign banks and local banks. It is well-known (and partly established in a factual manner in Chapter Six) that the local banks are generally less liquid than the foreign banks and hence liquid reserve requirements are going to show up weaknesses in the indigenous banks before they affect the foreign banks. It is probably for this reason more than any other that the Central Bank has adopted a cautious approach to this question of legal reserve requirements. Secondly the international nature of banking in Beirut makes it very difficult for the Central Bank to define precisely what eligible assets and liabilities should be. There is simply the problem of how you treat the very large foreign currency deposit element in total deposits.

Thus with the difficulties of liquidity requirements still taxing the Central Bank, the Bank is unable to move into other areas of monetary control such as the control of interest rates or the control of public debt operations. This serves to illustrate the point made earlier in this chapter that there is an inter-dependence between the control of credit institutions and the role of the Central Bank in the promotion of economic development. Monetary control in Lebanon has largely developed out of a number of ad hoc policies by the government to counteract a

series of financial crises in the system, using the 1963 Monetary and Credit Act as a base. There is no doubt that the presence of the Central Bank has had a regulating effect on the banking sector; but so far it is difficult to see what permanent effects the Central Bank has had on the ability of the financial sector to generate funds for development within Lebanon. It is to this question of the provision of finance that we now turn in Chapter Nine.

C H A P T E R N I N E

The Financing of Development in Lebanon

One of the basic points that has been established in this thesis is that the arrangements or institutions that exist by which savings are converted into loanable funds available for investment will determine how effective a given volume of savings is in terms of capital formation. In particular, emphasis has been laid on a number of institutional constraints, such as the narrowness of the domestic market, the dual nature of the interest rate structure, the existence or non-existence of capital markets to name a few. In addition it has also been demonstrated that monetary control through the Central Bank can have an effect on the "efficiency" of any given financial structure. This chapter brings together the numerous points that have been made in previous chapters to see what effects different financial structures and financial instruments may have on economic development.

Hicks, in discussing some of the monetary aspects of growth processes, points to the importance of financial

intermediaries in that they, through acquiring information, are able to narrow the margins between lending and borrowing rates, such that a given volume of savings is more productive than in an internal finance situation. Hicks goes on to say,

> ". . . The beginning of a process of expansion . . . might occur because of real factors . . . raising the real . . . rate of profit. But it might also occur because of financial improvements, diminishing the size of our 'gap'; thereby permitting access to funds for improvements which could have been made earlier, if the necessary funds had been forthcoming. It is not savings only that are required, but a channel of communication between potential savings and potential real investment . . ."[1]

It is this "channel of communication", as Hicks refers to it, which we can visualize as our financial sector. This financial sector consists of a number of financial intermediaries, generating financial instruments controlled, in some sense by a monetary authority. It is the interrelationships between these three, as defined in various ways in the preceding eight chapters, which will determine the efficiency of any given volume of savings in terms of a final amount of capital formation.

We have already seen that by certain criteria, it could be argued that Lebanon possesses a mature financial system, in that the financial inter-relations ratio (F.I.R.) is in excess of unity. Equally we have seen, on Kurosaki's

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1. J. Hicks, Capital and Growth, (London: Oxford University Press, 1969) p.290 n.

criteria, Lebanon has many of the characteristics of an under-developed financial structure. A major aspect of the difficulty of analysing the potential of the Lebanese financial sector is the fact that deposits in the banking system are predominantly in foreign currencies and the uses made of insurance facilities, in particular, are largely exogenous to the domestic economy. Thus the financial capability of the financial sector perhaps ought to be measured in terms of domestic currency deposits or, perhaps, all deposits held by residents. If the former measure is used total deposits in mid-1974 would amount to LL2469 million or on the latter measure LL6646 million (taking 85% of all deposits to be owned by Lebanese: this is the figure used by the Central Bank in 1973[2]). In both cases the F.I.R. drops considerably; to 0.4 in the first place and about unity in the second. However, there does seem to be evidence that the growth of total deposits (including foreign currency deposits) has been paralleled by an equal growth of advances. Now it is possible that the growth of advances has been based solely on local currency deposits; which would have led to a considerable loss in liquidity, as suggested in chapter seven. As the Central Bank has not been active in winding up a lot of banks over the last few years and has in fact imposed

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2. Banque du Liban, Rapport sur l'Annee 1973.

more stringent liquidity requirements on the financial sector, then it must be assumed that some domestic credit expansion has taken place on the basis of foreign currency deposits.

One question that has not been answered is whether the expansion in advances represents the total demand for loanable funds, or whether there is, in some sense, an unsatisfied demand for finance; a demand which is unsatisfied because of strictures within the financial system. We can see, therefore, that any financial system may be simultaneously growth-induced or growth-inducing.[3] A growth-induced financial system implies that the financial system responds to demands put upon it. Such a system may be referred to as a demand-pulling one. In this case the financial system may behave invariantly with respect to growth in real output or may in fact inhibit growth in real output. In this second case it is assumed that the demands put upon the financial system in fact cannot be met and, therefore, there is an element of unsatisfied demand. In this way entrepreneurs wishing to expand output in certain sectors may find that the necessary financial services are not available and, therefore, the expansion may be abortive. As we have seen, the reasons for this non availability of financial services may be many.

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3. Part of this analysis is based on that presented by H.T. Patrick, "Financial Development and Economic Growth in Underdeveloped Countries", Economic Development and Cultural Change, Vol. 14, No. 1, January 1966.

Restrictive banking legislation may not allow financial institutions to expand at the appropriate rate. There may be a demand for long-term loans by entrepreneurs which financial institutions cannot meet due to the high risk and illiquidity problems. In this context it is important to note the emphasis placed by many development economists on the creation of development banks to provide long-term finance to industry and agriculture. Such development banks normally require government support for their activities and may not develop in countries where the government wishes to adopt a neutral role in development. Financial institutions may not be able to mobilize individual savings at a sufficient rate to keep up with entrepreneurial demand. In this case some rationing procedure will be required, either through raising interest rates or restricting loans to the very short term. In either case the rate of investment will be slowed down with a consequent reduction in real economic growth. Finally a problem which is very relevant in the Middle East is the attitude of Muslims to interest charges. When usury is against religious principles this may inhibit the growth of financial institutions and ultimately real output. Although this is a problem in the Middle East it appears not to be important in Lebanon. A growth-inducing financial system is a system which actively influences the pattern of investment in an economy and, therefore, the

composition of final output. Again such a situation may be referred to as a supply-pushing one. In this situation the financial system may have two roles: to divert resources from the traditional to modern sectors; and actively to stimulate entrepreneurs in this sector to take up all the loans that are on offer. All this implies that the financial system is able to provide all the services entrepreneurs may require before these services are called upon. This slightly unusual situation may be described in two different ways. Firstly a financial system may develop in response to demands put upon it by, say, the agricultural sector. The rate of savings in this sector may be sufficiently large for financial institutions to be able to offer additional financial services to the nascent industrial sector. The opportunity of available finance may encourage entrepreneurs in the industrial sector to revise their investment plans in an upward direction hence providing a more positive impetus to industrialization.

Secondly the financial system may acquire funds which are very much in excess of the present investment outlets. In this case the financial system will expand with respect to the funds deposited into it; but may find insufficient opportunities to loan the money internally. It could be argued that this is true of Lebanon today; that the financial facilities available in Beirut encourage a regional inflow

of funds in excess of the domestic economy's absorptive capacity. In this case the banks move funds into overseas markets.[4] However as the domestic absorptive capacity of the economy expands, then more demands will be put on the financial system requiring a switching back from overseas markets to domestic markets. However if domestic markets tend to offer long-term low profitability projects and overseas markets offer short-term high profitability assets, then this switching back will not occur. It appears as though Lebanon is in the middle of this type of scenario. The implications of this situation can now be discussed more fully in terms of the Lebanese Six-Year Development Plan, 1972-1977.

The Lebanese Six-Year Development Plan calls for a 7% real growth in gross domestic product from 1972 to 1977. The overall investment requirement for the Plan is LL7,200 million in 1969 prices, out of which 24% will be public sector investments. To achieve the 7% global growth target requires an annual investment input of 18% of G.D.P.[5] In fact investment averaged 21% per annum over

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4. J.N. Bridge, "Financial Structure and Development in Saudi-Arabia", Proceedings of the Seminar for Arabian Studies, Vol. 4, 1974. pp.10-17.

5. United Nations Economic and Social Office in Beirut, (UNESOB), The Lebanese "Six-Year Development Plan 1972-1977" : An Assessment, Occasional Paper No. 2, Beirut: March 1973, p.13.

the 1964-1969 period. This implies a fall in the gross marginal capital-output ratio from 4.50 from 1964-1969 to 2.55 from 1972-1977. However UNESOB suggest that as most projects in the public sector investment programme appear to have a high gross marginal capital-output ratio; then this predicted fall is probably too optimistic.[6] If a gross marginal capital output ratio of 3.00 is assumed then investment must average 21% of G.D.P. for the 1972-1977 period. We can look at the implications of this total investment programme for the financial sector both in terms of public investment and private investment.

The public sector is expected to invest LL1,740 million from 1972-1977, or an average of LL290 million per annum - total budgeted expenditure in 1971 amounted to LL774 million, of which approximately LL100 million could be described as investment expenditures.[7] It is very unlikely that this rapid increase in public sector investment necessary to meet the Plan's targets can be financed through direct revenues. The inefficiencies of the direct taxation system in Lebanon are well-known, and, politically, indirect taxes are difficult to raise.[8] This means that the investment programme will have to be financed through a borrowing

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6. Ibid., p.13.

7. Ministry of Planning, Budget Estimates 1972.

8. In particular Dr. Saba, as Minister of Finance, attempted to increase customs duties to raise LL65 million in revenues in 1971 and had to withdraw his measures as it resulted in a series of strikes and boycotts.

programme. Lebanon has already had recourse to other Arab sources for investment finance and, internally, the Treasury borrowing limit has been raised to LL200 million; but it is unlikely that the necessary increase in funds can be expected to come directly from these sources. Here the role of the financial sector can be analysed. One obvious point is that the government could increase substantially its borrowing requirement by issuing securities to the public through the banking system. At present estimates this could involve up to LL200 million per annum, almost twice the outstanding volume of treasury bills in existence. However, for such borrowing to be successful, the securities have to be offered at rates which are competitive with rates in short-term markets. Equally rediscounting facilities must be available at the Central Bank for any banks that take up this kind of medium-term paper.

It may be that in purely financial terms the volume of public sector borrowing envisaged is quite acceptable to the financial sector (in current terms, the borrowing requirement would represent 2.4% of total deposits); but it is doubtful whether psychologically, such an increase in public sector borrowing would be accepted. The general reluctance of the banking sector to hold the two treasury bill issues is indicative of this. Although it must be admitted in the case of the treasury bill issues, the

rates offered were not competitive with other short-term rates.

If the financing of the public sector investment programme is going to be difficult, then this is doubly true of the private sector programme. Total private sector investments are expected to total LL5,460 million over the 1972-1977 period, or LL910 million per annum at 1969 prices. From the data that is available on total advances it is impossible to say what proportion of total advances are new, in the sense that they represent a nett addition to capital formation. In the first place advances include loans to finance current expenditure and, secondly, loans on the capital expenditure side include finance for replacement investment.

Thus it is impossible to say what proportion of the growth in total advances represents an addition to capital formation. There is only one indicator that we can use to try and quantify the argument presented here. By looking at the growth of total advances from 1970-1973 (Table 7.7) we can see that the total growth in each year has been less than the predicted average of LL910 million required by the Plan, and it must also be recognized that the Plan requirements are in 1969 prices, whereas the data in Table 7.7 are in current prices.

The full utilization of deposits within the banking system is going to require some system whereby medium-term

and long-term loans become more attractive to individual banks. New investment obviously has a risk aspect to it and banks will wish to be compensated for sacrificing liquidity and possibly acquiring more uncertainty. It is unlikely that direct lending by the banks can provide the appropriate quantity of finance for industrial developments and, therefore, medium and long-term lending institutions are required; who would borrow directly from the banking system and issue indirect securities for industrial investment. Such institutions would require to be supported by government guarantees considering the risk involved. As Nevin has commented,

> ". . . It is inherent in an under-developed economy that the risk attached to investment in local enterprises is large; private individuals cannot reasonably be expected either to assess the extent of this risk fairly, or to take it entirely on their own shoulders. It is a proper function of government in such circumstances to provide some guarantee against these risks; it is the only organization which is able to spread its own risk over the entire economic life of the community, and it is in fact the only part of the system whose function is to accept the uncertainties inherent in the development of the economy as a whole . . ."[9]

The problems inherent in the development of medium-term loans centre around the time profile of deposits and advances. Given a certain degree of volatility in deposits (as demonstrated in Chapter Seven), the banking system will

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9. E. Nevin, Capital Funds in Underdeveloped Countries, (London: Macmillan and Co. Ltd., 1963), p.75.

obviously be reluctant to extend loaning facilities beyond the short-term, say less than one year. Thus as deposits in the banking system grow there is no commensurate growth in medium-term and long-term loaning facilities. This discrepancy in time profiles can be bridged with the creation of specialised institutions, backed by Central Bank guarantees on their assets and liabilities. These guarantees are important if the new financial intermediary wishes to attract deposits from the banking system itself. This involvement with the banking system is important in that it discourages the development of a dual financial system: the private banks on the one hand and the government controlled and backed medium-term and long-term loaning institutions on the other; both pursuing their separate businesses. One suggestion for developing these two types of financial intermediaries together was put forward by Asseily in 1966.[10] He suggested that a medium-term investment bank should be created that would accept deposits from the commercial banks and issue in return a cash certificate with a maturity date, both negotiable and discountable at the Central Bank. Thus if a bank wished to increase its liquid reserves it could discount the cash certificate at the Central Bank, without directly affecting the lending abilities of the investment bank.

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10. A.E. Asseily, Central Banking in Lebanon, (Beirut: Khayat Book and Publishing Co. 1967) pp.125-127.

The interest rate offered on the deposits with the investment bank would have to be competitive with existing short-term rates in world money markets, but, presumably, lending rates would not have to be equally high, if the government were prepared to subsidize medium- and long-term loans, by reducing the costs of borrowing.

This type of "bridging" mechanism is by no means a new idea; but it does serve to illustrate one very important point; that is that some form of government intervention is almost inevitable if a medium- and long-term investment bank is to become a viable proposition. So the extent to which such finance is available is very much dependant on the attitude of the government. Quite clearly the commercial banks will not create this facility entirely on their own within the period of time being discussed, thus the onus rests with the government through the Central Bank. This is why the absence of any remarks about financial arrangements within the Six-Year Plan is quite remarkable.

The one development that is worth mentioning in some detail is the establishment of the National Bank for Industrial and Touristic Development. This bank was established in 1973 with an initial capital of LL60 million, largely subscribed by the government. It's Board of Directors includes representatives from a number of indigenous banks and in conception this bank is intended

to be a focal point for industrial investment within the indigenous banking sector. By the end of 1973 some LL10 million of loans had been approved; but this represents less than 1% of loans extended by the commercial banks as a whole.[11] An alternative to this sort of local development is the creation of an international development bank. An early example of this was the proposed Arab Development Bank suggested in the 1950's and now developed as the Arab Fund for Social and Economic Development. This type of Fund, along with the longer-established Kuwait Fund, have the capacity to offer long-term loans at below market rates for industrial and infrastructure investments. One of the principle problems of utilising such Funds is the question of access. Although both Funds have experts who screen applications, it is not clear whether small-scale private enterprises are accorded equal treatment with semi-public and public bodies. This problem does not apply only to small-scale industries in Lebanon; it is much more a problem for all developing countries. As a recent U.N.-sponsored report stated,

> ". . . The problem of financing industrial development will not be solved unless indigenous, regional and national institutions capable of mobilising and channelling funds to industry and of studying and promoting industrial enterprises are created. There

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11. The Arab Economist, Vol. VI, March 1974, No. 62, p.46.

> exists at present, in the Arab countries, several specialised institutions, but these have not, as yet, played an important role in financing or establishing Arab industries because of their very structure, shortage of funds and the nature of their credit policies . . ."[12]

The situation in Lebanon at the present time is that in total funds within the banking sector are probably sufficient to meet all development requirements, but these requirements are largely long-term in nature, whilst the funds deposited in the banking system are short-term in nature. In addition there is a further complicating factor in that a large proportion of these funds are denominated in foreign currencies. Thus the total funds within the banking sector overestimate the extent to which the financial sector is capable of increasing domestic capital formation. If banks tend to concentrate on the short-term end of the market, then their role in the financing of development will be limited and equally this concentration will affect the rate at which the economy can develop.

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12. "Financing Arab Industrial Development", paper prepared by the Industrial Development Centre for Arab States, Libya, for the Third Conference on Industrial Development for Arab States, April 1974, (United Nations Industrial Development Organization Document No. IDC3/1P/2, April 1974), p.5.

C H A P T E R T E N

Summary And Conclusions

Part I of this thesis developed a number of ideas, particularly those of Goldsmith, Gurley, Shaw and McKinnon to show that financial development could have an effect on real growth. Part II of this thesis has described recent developments in the Lebanese financial sector and has sought to prove that the financial developments that have occurred have not been conducive to real resource growth. This conclusion stems from two main points. Firstly the international nature of the financial system has exposed the Lebanese financial system to strong and persuasive exogenous factors. This coupled with a non-existent and then hesitant form of central bank control has created a financial system largely exogenous to the domestic economy and until quite recently, unregulated.

The approach in this thesis has been a pragmatic one. There is no one body of economic theory that can be called upon to explain the complicated inter-relationships between financial growth and economic development. In this vein the view of Hicks, that,

> ". . . Underdevelopment economics is a vastly important subject, but it is not a formal or theoretical subject. It is a practical subject which must expect

> to call upon any branch of theory (including non-economic, for instance sociological, theory) which has any relevence to it,"[1]

is important. The discussion on the various factors influencing financial growth, contained in Part I, ended with the conclusion that only a country-by-country approach to financial development could possibly capture the many factors involved. This approach has been adopted in Part II and the thesis has demonstrated that whilst financial growth in Lebanon in terms of total deposits in the banking system, has been rapid, financial deepening, in terms of the range of financial instruments offered by the financial system, has not occurred. This has resulted in a financial system which has the overall capability to finance economic development within Lebanon, but has not generated the range of instruments to make this capability effective. This situation has resulted from the growth of a largely unregulated banking system, with the majority of the deposits denominated in foreign currencies. These foreign currency deposits have had an effect on liquidity, the structure of advances and the general impacts of central bank policy. Far from foreign banks and foreign currency deposits having a positive effect on the banking system, as implied by Goldsmith,[2]

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1. J. Hicks, Capital and Growth, (London: Oxford University Press 1969) p.3-4.

2. Chapter Three, page 78.

they have resulted in the development of a financial system which is largely exogenous to the Lebanese economy.

The basic conclusions from all this are that a more decisive form of central bank policy is required. Regulations concerning foreign currency holdings need to be strengthened, possibly requiring banks to hold matching deposits in Lebanese pounds. This might have the effect of reducing foreign currency deposits; but presumably, the only loss here would be foreign exchange earnings, estimated at about $100 million per annum and this loss would not be complete. The gain would be that a financial system would be created that would be more inward-looking in its investment policies, which should be to the benefit of the Lebanese economy. An alternative would be to provide a sort of banking "free zone" or dollar market in Beirut, as proposed by Hoss in 1974.

> ". . . One of the requirements for the development of the banking sector and with it the financial market, in Lebanon, is the creation in this country of an Arab dollar market similar to the Asian dollar market set up in Singapore and the Euro-dollar market . . . we mean a market for trading in the various major world currencies, not only the U.S. dollar, although this dollar is likely to be at the centre of international financial transactions, as it has always been in the European and Singapore markets. The setting up of the required market depends, to a large extent, on the establishment of what may be loosely called a 'banking free zone' based on the exemption of bank deposits belonging to non-residents and made out in foreign currencies from interest tax, statutory reserve and deposit insurance charges."[3]

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3. S. Hoss, in a speech delivered to the Lebanese Management Association, as reported in Monday Morning, 25th February 1974.

Hoss went on to argue that the "key" to Lebanese development lay in the growth of a financial system capable of acting in a regional capacity for surplus oil funds. This only seems to be half of the picture. Lebanon, at the present time, is probably the best equipped of middle-eastern countries to take advantage of surplus oil funds, but this advantage creates disadvantages in the domestic market, as has been outlined in the last four chapters. Unless there is some physical separation of non-resident foreign currency deposits, then the Lebanese financial system will continue to be affected by the behaviour of world short-term money markets to the obvious disadvantage of domestic capital formation.

Appendix 1

Law of September 3, 1956, on banking secrecy

Article 1. Banks established in Lebanon under the form of joint-stock companies as well as foreign banks; branches are subject to professional secrecy on condition that they obtain the special relative authorization from the finance minister.

The Bank of Agriculture, Industrial and Real Estate Credit is not subject to the provisions of the present law.

Article 2. Managers and employees of the banking establishments referred to in the first article as well as persons who are acquainted through their quality or their function, by one means or another, with bank books, operation and banking correspondence, are bound to absolute secrecy, in favour of the bank's clients, and cannot disclose to anyone whatsoever, private individual or an administrative, military or judicial authority, clients' names, their assets and facts of which they are aware, except with the client's written authorization, or his heirs' or his legatees', or in case he should be declared bankrupt, or in the event of a dispute between the client and the bank resulting from banking relations.

Article 3. Banking establishments referred to in the first article are authorized to open to their clients code number deposit accounts whose owner is known only to the bank's director or his proxy.

The identity of the holder of a code number deposit account cannot be revealed except with his written authorization, or his heirs' or legatees', or in case he should be declared bankrupt, or in the event of a dispute between the client and the bank resulting from banking relations. The letting of safes can also be effected under code number in the same conditions.

Article 4. No seizure can be made on the holdings lodged as deposits with the banking establishments, referred to in the first paragraph, without the written authorization of their owners.

Article 5. The authorization referred to in the preceding articles may be stipulated beforehand in every contract, and may not be withdrawn except by the common accord of all the contracting parties.

Article 6. The present law is no bar to the organization, only among the banks referred to in the first article, of exchanges under the seal of secrecy of information relating to their clients' debtor account in order to safeguard the security of their investments.

Article 7. The banking establishments referred to in the first article may not oppose the professional secrecy created by the present law to requests which judicial authorities should formulate in their proceedings relating to unlawful growth of wealth initiated in execution of Legislative Degree No. 38 of February 18, 1953 and of the law of April 14, 1954.

Article 8. Any intentional breach to the requirements of the present law shall make its author liable to a term of imprisonment of between three months and one year. The beginning of execution is subject to the same penalty. Public action may not be set into motion except upon the complaint of the injured party.

Article 9. All provisions contrary to the present law or inconsistent with its tenor are abrogated.

Article 10. The provisions of the present law shall be enforced two months after its publication in the Official Gazette.

Appendix 2

Classification of Banks Operating in Lebanon: 1974

Foreign Banks (Non Arab)

1. Banco di Roma
2. Banque Nationale de Paris (Intercontinentale)
3. The British Bank of the Middle East
4. Algemene Bank Nederland N.V.
5. The Chase Manhattan Bank
6. First National City Bank
7. The Chartered Bank
8. Bank Saderat Iran
9. Moscow Narodny Bank Limited
10. Bank of America (National Trust and Savings Association)
11. Habib Bank (Overseas) Limited
12. The Bank of Nova Scotia

Foreign Banks (Arab)

13. Arab Bank Limited
14. Rafidain Bank
15. Saudi National Commercial Bank
16. Jordan National Bank
17. Arab African Bank

Lebanese Banks (SAL) with Majority Participations of Foreign (Non Arab) Banks

18. Banque Française pour le Moyen-Orient

19. Banque Libano-Française

20. Banque Sabbagh

21. Banque G. Trad (Crédit Lyonnais)

22. Banl al-Mashrek

23. Société Générale Libano-Européenne de Banque

24. The First National Bank of Chicago (Lebanon)

25. The Royal Bank of Canada (Middle East)

26. Continental Development Bank

27. Crédit Suisse (Middle East)

28. Société Nouvelle de la Banque de Syrie et du Liban

29. Rif Bank

30. United Bank of Lebanon and Pakistan

31. Litex Bank

32. Trans-Orient Bank

33. The British Bank of the Lebanon.

Lebanese Banks (SAL) with Majority Participation of Foreign (Arab) Banks

34. Banque Misr-Liban

35. The Arab Libyan Tunisian Bank

Other Lebanese Banks (SAL

36. Banque Tohmé

37. Société Bancaire du Liban

38. Banque Libanaise pour le Commerce

39. Banque du Liban & d'Outremer

40. Federal Bank of Lebanon

41. The National Bank For Industrial & Touristic Development

42. Banque de la Méditerranée

43. Banque Chartouni

44. Banque Saradar

45. Bank of Beirut & The Arab Countries

46. The Lebanese Arab Bank

47. Banque J. Lati & Fils

48. Beirut Riyad Bank

49. Investment and Finance Bank

50. Banque Pharaon & Chiha

51. Banque de Credit National

52. Mebco Bank (M.E. Banking Co.)

53. Banque Byblos

54. Advances & Commerce Bank (Adcom Bank)

55. Banque de Financement

56. Banque de l'Industrie et du Travail

57. Banque Libano-Brésilienne

58. Crédit Libanais

59. Banque Beyrouth pour le Commerce

60. Banque Audi

61. Banque Nasr Libano-Africaine

62. Bank of Kuwait & The Arab World

63. Banque Joseph Geagea

64. Banque du Crédit Populaire

65. Banque Majdalany

66. Commercial Business Bank

67. Bank of Beirut

68. Banque des Cèdres

69. Prosperity Bank of Lebanon

70. Rabiya Bank

71. Jammal Investment Bank

72. Banque de l'Essor Économique Libanais

73. Banque Libanaise des Émigrés

74. Liberal Bank

75. Banque de la Békaa

76. Banque de Crédit Agricole

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