A Central Bank For the Economic Development of Lebanon.

by

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Abstract

This study is an analysis and appraisal of the newly established central bank in Lebanon. The Charter granting the privately owned Banque de Syrie et du Liban the privilege of note issue in Lebanon expired on 31st March 1964 and was not renewed. A state owned institution, the Bank of Lebanon, was created to take over the functions of the Issuing Department of the Banque de Syrie et du Liban and was given central banking powers. This was the most important development in Lebanese banking history since the Banking Secrecy Law of 1956.

When a central bank is newly established in a developing country, there is always the danger that it will be domihated by traditional notions of central banking, and insufficient regard paid to the particular characteristics of the economy in which it is to operate. The result may well be the establishment of an ineffective central bank. The problem considered here is whether in Lebanon there was a need for a change from the old system, that is whether or not the Banque de Syrie et du Liban was adequate for the requirements of the country, and if not what sort of a change was required.

The development and working of the Lebanese banking system is analysed with special reference to the role that might be required of a

central bank. Particular emphasis is placed on the significance of the foreign banks and the very active money market which traditionally provided an effective lender of last resort. The problems of economic development in the Lebanon are outlined and in the light of these problems, of the nature of the economy and of the Government's economic plans, the important functions that could well be served by a central bank are discussed.

It is concluded that the Banque de Syrie et du Liban, essentially an Issuing Bank, was not adequate for the requirements of the economic development of the country, and that a central bank was needed. But the Bank of Lebanon, as actually constituted will only marginally help in the economic development of the country.

Acknowledgements

The main difficulty I have encountered in writing this thesis has undoubtedly been the collection of adequate and reliable statistics. Official Lebanese sources being particularly dry on the subject and the new Central Bank, which collects very detailed information from commercial banks, being secretive and over cautious, I have often had to rely on private information supplied by Lebanese and foreign bankers who wish to retain their anonymity and to whom I am indeed grateful. I owe much to Mr. G. Corm of the Ministry of Finance who provided me with valuable material used in Chapter III and discussed some of the points with me.

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CHAPTER I

INTRODUCTION

The purpose of this chapter is to provide a background for a discussion of the problems associated with the establishment of a Central Bank in the Lebanon, which is described in the latter part of the chapter.

I. The 'Fashion' Of Central Banking

"A central bank is not a natural product of banking development. It is imposed from outside or comes into being as the result of government favour."[1] "It is an institutional arrangement that may be made to serve any one of a number of 'purposes'..." its essence being"... the discretionary control of the monetary system".[2] The tasks of such an institution "or any other human institution, are surely to respond to the needs of the environment in which they exist."[3] However, "looking back, it is impossible to resist the statement that the foundation of central banks has been partly a matter of fashion".[4] The fashion of central banking has by no means been uniform and does not go much

1. Smith, V.C, The Rationale of Central Banking, London, King, 1936, p. 148.
2. Sayers, R.S, Central Banking after Bagehot, Oxford University Press, 1957, p. 1.
3. Nevin,E, in a book review, Economic Journal, September 1965, p. 592.
4. Sayers, R.S. "Introduction" to Banking in the British Commonwealth ed. by R.S. Sayers, Oxford, Clarendon Press, 1952, p. xi.

beyond the 1920's. Ricardo and his age were against what he called 'tinkering with the currency' by the 'company of merchants' who directed the Bank of England. Adam Smith's Invisible Hand would regulate - so it was thought - the monetary systems that adhered to the International Gold Standard and followed the rules of the game. The objective of monetary policy then was convertibility, but meaning by that word the avoidance of fluctuating exchange rates which would result from severing the fixed link between the national currency and gold.[1]

The Gold Standard seemed to work until the First World War without any regular conscious intervention from the Authorities. There were occasions when emergency measures to protect the convertibility of certain currencies were required, but the continuing stability and convertibility of sterling or of the currencies of other leading Gold Standard countries were never seriously questioned. The modern phenomenon of 'hot money' was known in those days, but as far as the Gold Standard

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1. Before the First World War currencies were always freely 'convertible' in the modern sense of the word, but not always at a fixed price.

   The normal working of the Gold Standard implied that in a given country an influx of gold resulting from an export surplus or a certain favourable state of the country's international capital transactions, would lead to an expansion of credit and a reduction in interest rates. Purchasing power was thereby increased and more imports would come in worsening the trade balance. Furthermore, lower interest rates might cause an export of capital and deter any import of capital. In this way, the trend would change and the influx of gold would be arrested and possibly reversed.

countries were concerned it was rather of the politically inspired or capital flight variety than the destabilizing speculative variety induced by expectations of exchange rate movements beyond the limits of the gold points. There were virtually no instances of major runs on any of the Gold Standard currencies.[1]

However, talk about the merits and drawbacks of central banking as contrasted to 'free banking', began to be heard in the third quarter of the nineteenth century at the height of laissez-faire theories and policies, but it is significant to note that it was then mainly with relation to the control of commercial banks and their note-issuing activities. Even the most doctrinaire free-traders, with the exception of Courcelle-Seneuil in France, were unwilling to apply laissez-faire theories to the business of banking which they regarded as an activity requiring some special regulations.[2] But what sort or form the banking system should take was still a matter of dispute and what regulations should apply to it remained an open question for several

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1. Bloomfield, A.I., Monetary Policy under the International Gold Standard: 1880-1914, Federal Reserve Bank of New York, October 1959.

2. Smith V.C., op. cit. p. 2.

decades.[1] The view that central banking policy could facilitate the achievement and maintenance of a reasonable stability in the level of economic activity and of prices was scarcely thought about before the First World War; prudent banking and the automatic International Gold

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1. In his Plan for a National Bank, (John Murray, Albemarle Street, 1824) Ricardo put forward a plan for ending note issuing by commercial banks, including the Bank of England, and the establishment of a National Bank as the sole issuing institution, to belong to the Nation and to be run by 5 highly independent Commissioners who could only be removed from office by a vote of one or both Houses of Parliament. The Plan was published after his death. However, the prime motive of Ricardo seemed to be the ending of the privileges of the Bank of England, for which he had much contempt; no regulation of the banking system was envisaged, nor any intervention in the economy. The National Bank was to be an Issuing Bank only.

   It is interesting to note here that in Australia, as recently as 1947 the question of the regulation of banking was widely debated and was subject to Court procedures. The matter arose over a nationalisation attempt by the Labour Government. The Australian High Court declared that banking was like any 'trading' profession and should therefore be free of interference. An appeal to the Judicial Committee of the Privy Council was dismissed, but their Lordships, while declaring that nationalisation would be unconstitutional - because it would authorise the total prohibition of private banking among the States which would mean restricting inter-State trade commerce and intercourse - agreed that regulation of Trade, etc... was compatible with absolute freedom, and therefore banking could be subject to certain regulations. Thus the trading banks' activities were regulated by the Banking Act of 1945 but the banks could not be nationalised. For details of the Privy Council's decisions, see: "Judgement of the Lords of the Judicial Committee of the Privy Council", delivered 26 October 1948.

   As will be shown in the following chapter, banking in Lebanon remained regulated by the same laws as any other act of commerce until March 1964.

Standard were still supposed to achieve that unaided.[1]

The Gold Standard was suspended during the War with the belief that as soon as the hostilities ended, it would be reinstated. But conditions had changed after the War and the financial difficulties which prevailed during the first years of peace resulted in a severe strain on the currency systems of the world. These proved unable to withstand it and were seriously disrupted. Price levels and exchange rates fluctuated violently everywhere. Countries trying to maintain a more or less fixed exchange rate to the dollar experienced a serious decline in wholesale prices which seems to have started in Japan. Others, pursuing a continuous policy of inflation, saw the value of their currencies in terms of the dollar decline rapidly.[2]

However, a quick return to the Gold Standard was still the aim and in the early 1920's

> "... the fashion of central banking was rooted in the broader movement of monetary reconstruction after war-time and post-war upheavals".[3]

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1. The Federal Reserve System was created in 1913 but the primary motive was really the creation of a lender of last resort which could expand reserves, the need for which arose in the 1907 crisis. This is described later.

2. For full discussion see The Course and Phases of the World Economic Depression. Report presented to the Assembly of the League of Nations, First Revised Edition, Secretariat of the League of Nations, Geneva, 1931.

3. Sayers, R.S. ed. Banking in the British Commonwealth, 'Introduction', op. cit. p. x.

It was felt that central banks could play a useful role in the re-establishment of the Standard, and both official and academic expositions stressed their importance and the part they could play in bringing about a reasonable stability in the level of prices-through changes in interest rates and the availability of credit-and in the level of economic activity-through discretionary action at the centre aimed at preventing temporary disequilibria in the balance of payments from causing unnecessary disturbances in the economy. The feeling that central banks were needed in this context was clearly demonstrated at the 1920 Brussels Conference of international experts who, envisaging a world of foreign exchange stability proposed without qualification that in countries where there is no central bank, one should be established.[1]

The enthusiasm for a quick return to the Gold Standard was soon followed by disappointment as the world economic conditions seemed to deteriorate. A distrust of the central banks of the big countries set in with the suspicion that they were enjoying too free a hand in the manipulation of the world's monetary and capital markets. Nationalistic feelings were aroused and national independence in monetary affairs then became the fashion. Political arguments had made a breach in the

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1. de Kock, M.H., Central Banking, 3rd edition, Staples Press, London, 1954, p. 19.

economic reasoning that should lie behind the establishment of central banks, and these started growing everywhere on a new basis:

> "The world-wide demand for central banking arose from fundamental economic and political trends towards nationalism ... Any attempt to explain the birth of these war babies in purely economic terms is bound to be abortive; and equally ineffectual is bound to be any attempt to discover whether they would have come into being had pure economic reason prevailed. War babies are more often the products of impulse than reflection; and as for economic reason, attempts to make it pure sometimes succeed only in making it sterile".[1]

Up till then the 'fashion' as Professor Sayers calls it, was to insist on the independence of the central banks, i.e., their total freedom from any Governmental control or influence. The ideals were the privately owned Bank of England - shareholder owned - and the Federal Reserve System - bank owned - both of which had no allegiance to any Government. This view was strengthened in the 1920's by the disastrous experience of some continental countries which subjected their central banks to their Treasuries and ended up with hyper inflations.[2] However, in the 1930's the potentialities of central banking were gradually

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1. Plumptre, A.F.W., Central Banking in the British Dominions, University of Toronto Press, Toronto, Canada, 1940, p. 159. Miss V. Smith says in this context: "An examination of the reasons for the eventual decision in favour of a central banking as opposed to a free banking system reveals in most countries a combination of political motives and historical accident which played a much more important part than any well considered economic principle", op. cit. p. 2.

2. Especially in Central Europe where currencies lost practically all their value. Monetary re-organisation in these countries included drastic financial reforms which turned deficits in the public finances into surpluses and thus reduced the Governmental demand for advances from Central banks.

discovered and the Keynesian views on the role of the State in an economy were making their impact on the people. The fashion soon reversed itself and control of the central banks by the State began to be advocated, especially after the Second World War which brought deficit financing in many countries and the control of foreign exchange by the public authorities. Moreover, on the whole, the role of the State was gradually widening, and it was widely felt that a discretionary element in the running of the monetary system of the country was not only desirable, but also that it should come from the State. And so the world witnessed not just a proliferation of central banks but of state-owned central banks. Thus in the early 1930's state-owned central banks existed in only ten countries. By the end of the decade their number had increased to fifteen. After the War ten central banks were nationalised while all newly established ones were created as Government-owned institutions.[1]

In recent years the establishment of central banks has no longer been questioned. But the argument for them seems to have shifted heavily away from economics towards politics. Part of their role seems to have become similar to that of a national airline or a steel mill.

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1. For more details about the ownership of central banks see Sir T. Gregory, The Present Position of Central Banks, Stamp Memorial Lecture, 1955. University of London, the Athlone Press.

They have become a symbol of development and of national independence.[1] This view is very evident in the following quotation in connection with the establishment of a central bank in Syria to replace the privately and foreign owned Banque de Syrie et du Liban (BSL):

> "The BSL is a foreign bank which came to the country with the imposition of the French mandate. Now that Syria has attained its independence as a result of the evacuation of the French troops, it is no longer permissible to keep the right of note issue vested in a foreign institute whatever is the degree of its loyalty to the Syrian economy; nor is it permissible to entrust the function of a government's banker, fiscal agent and adviser to a foreign institution however endowed with the qualities of honesty, efficiency and zeal in pursuing the country's interests".[2]

Not only should central banks be created, but again they should be state-owned:

> "The Monetary Convention of 1938 which delegated to the BSL the performance of a basic public service, does not acknowledge the right of the State to supervise and intervene in the monetary policy of the Bank. And since it is within the competence of the State alone to determine what is in the public interest, it is therefore necessary that the State should have the necessary means to supervise and intervene in all affairs, including monetary affairs, that subject the public interest to danger".[3]

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1. "The creation of central banks ... is often regarded as being a sign of the desire of newly self-governing countries to assert their independence; it has been interpreted as a political rather than an economic development". Nevin E. Capital Funds in Underdeveloped Countries: The Role of Financial Institutions, Macmillan & Co. Limited, London, 1961, p.22

2. Ashshy G., The Syrian Monetary System (in Arabic) 3rd ed. Damascus, 1959, p. 150. My italics.

3. "The reasons for the Promulgation of the Basic Monetary System and the Establishment of the Syrian Central Bank" Law No. 87 of 28th March 1953 Prescribing the Basic Monetary System and the Establishment of the Central Bank of Syria, The Syrian Republic Press, March 1953, pp. 84-85 (In Arabic). My italics.

Such political factors, so clearly defined in the quotations above, have been very important in emerging nations and former colonies.[1]

It may be argued that political arguments are irrelevant when deciding whether to endow a country with a central bank, but public authorities would find it difficult not to yield to the tide running in favour of central banks, which tide is caused by the increased world importance that such an institution seems or is supposed to give to a country. And for political reasons alone it might be desirable to establish a State-owned central bank in a country. But on economic grounds alone a case can still be imagined where a state-owned central bank as opposed to an Issuing Bank is not necessary. For example, if one accepts the assertion that "the essence of central banking is discretionary control of the monetary system",[2] a central bank should be created only if discretionary intervention in the monetary affairs of a country is thought to be desirable. If again it is expected that the State would fulfil the role better than a private group,[3] it might be preferable if the central bank were State-owned. There is no a a priori economic reason for a country to have a central bank, nor for

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1. They have been important in Ceylon, Burma and some African territories, all of which have recently established central banks.

2. See footnote 2, p.8 above.

3. Thiw would be the case in a country where the public sector is very important in the economy and has the qualified people to perform this role.

such a bank to be State-owned.

Because the establishment of central banks became to some extent what Professor Sayers calls "A matter of fashion", proper thought was not always given to the question whether a particular country actually needed a central bank, i.e., to what such a bank could do for the commercial banks and the economy, and how best it would perform the role ascribed to it. There was a tendency to take as a model the older establishments, and then mainly the Bank of England which seemed to work on a mechanical basis; irrespective of the individuality of each economy and of the purpose - if any - for which a central bank was to be created, its role was visualised in what can be called "traditional terms", these being the principles and practices ruling in the United Kingdom and to a lesser extent in the United States in 1913: a central bank should provide the facilities of lender of last resort, control the commercial banking sector and dampen the cyclical fluctuations in the economy. This implied that the various countries which were being endowed with central banks required an institution to perform these functions. Not only was the role of the central banks visualised in traditional terms, but also the powers to be enjoyed by them in the carrying out of their responsibilities. Thus, and mainly with relation to the last two functions mentioned above, they were granted the traditional powers that the Bank of England possessed - powers to vary bank rate and to conduct open-market operations. Sometimes the power to change reserves requirements - as practised in the United States - was also granted them. Thus all purposes and all economies were to be served by identical central banks in identical ways.

This traditional approach to central banking has often led to the establishment - especially in under-developed countries - of central banks that are ill-adapted to the requirements of the economies in which they were to operate. Thus, for example, in some British Dominions, the English advisers brought in to help in the establishment of their central banks failed

> "clearly and consistently to give good advice. They recommended the introduction through tigid legislation, of the accepted practices of the Bank of England ... The advice of more recent years does not generally appear to be based upon accumulating experience in the Dominions where central banks had already been established. There is nothing to indicate that the advisers were aware of the anachronisms and anomalies attaching to the Bank of England, which they naturally used as their model; and the illogic of some of their advice suggests that they did not fully understand the technical implications of the accepted form of central banking which they were inviting the Dominions to adopt. If they were aware of the peculiarities of economic development in young countries, they made little allowance for them."[1]

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1. Plumptre, A.F.W., op.cit., pp 188-189.

Mr. Nevin repeats that last point:

> "It is generally agreed that the failure to appreciate adequately the implications of the differences between the state of evolution of the United Kingdom or the United States and that of many developing countries has resulted in the establishment of unsuitable and ineffective central banks in recent years."[1]

In fact, if a glance has been thrown on the earlier history of the Bank of England, a lesson could have been learnt to the effect that this institution was fulfilling a role that fell to it by reason of the circumstances and conditions in which it was working. In other words, it had adapted itself to the requirements of the country, namely the administration of its monetary affairs and the control and regulation of a sophisticated and highly developed structure of credit institutions. These requirements are by no means common to all countries. One cannot realistically talk of sophisticated credit institutions in developing countries: far from giving a central bank the powers to control them, it would be more sensible to ask it

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1. Nevin E., Capital Funds in Underdeveloped Countries op. cit p. 30

to help in their establishment and development.[1] In developing countries, a central bank will often be less a stabilisation device than a potential agency for development:[2] it may be required to help in the creation and growth of a capital market by making it possible for the banks to enter such a market, or it may directly finance development projects.

In certain countries with relatively undeveloped commercial banks, it may be desirable that the central bank should try to attract deposits and engage in ordinary commercial business. It would then foster credit to certain sectors. In this context a central bank would seek to fill what Professor Sayer calls "gaps unfilled by others".[3] In other countries it may not be desirable for it to do this as it may affect the willingness of other banks to co-operate. Even in countries with relatively developed commercial banks it may be

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1. "... in underdeveloped countries, the role of central banks is not to any great extent a restrictive one. It is more likely to be involved in expanding the scope of commercial banking and co-operative credit, ensuring that facilities are more widely used, and that the advantages of a market economy are achieved ... a tendency for general over-expansion of bank credit to the private sector does not exist as it does in more developed countries. Bank advances are small relative to national income, and tend to be confined to financing commerce, especially external trade." Low, A.R., 'The Varied Role of Central Banks', in Economic Record, December 1958, p. 320. For case studies of the growth of financial institutions in various developing countries, see Basch A., Financing Economic Development, Macmillan Co., New York, 1964.

2. See for example the argument of Newlyn W.T., and Rowan D.C., Money and Banking in British Colonial Africa, Oxford University Press, London, 1954, Chapter xiii.

3. Sayers R.S., Central Banking in Underdeveloped Countries, National Bank of Egypt, 50th Anniversary Commemoration Lectures, Cairo 1956.

desirable to let a central bank engage in commercial banking to provide it with a link with the money market.[1] Such a link would provide the central bank with a good chance of finding the technique most adapted to its own environment, and of taking the appropriate measures at the right time. So here again there is no general rule.

The last point raises the problem of the powers that central banks are able to exert in underdeveloped countries. As noted earlier, the tendency has been not only to ascribe a traditional role to the central banks but also to give them traditional weapons of monetary policy which have often proved ineffective. Bank Rate changes and open market operations are not ~~operative~~ effective in countries where banks do not and generally cannot keep stable cash ratios; they are equally inoperative when for one reason or another banks do not have much recourse to the central bank for funds. The maintenance of stable cash ratios implies the presence of a developed market for short-term money where the banker is able to move in and move out rapidly at a low risk of loss. This means of course that the assets obtainable

1. "Being in the market, it [the central bank] would be in a better position to keep in touch with the market; and secondly, it may directly influence the shape of the credit pyramid by varying the size of its own contribution." Sen S.N., Central Banking in Underdeveloped Money Markets, Bookland Limited, Calcutta, 1952, p. 144.

in that market can easily be disposed of. One way of liquefying an asset is to rediscount it at the central bank, which implies that this institution should stand ready to buy that particular type of asset any time, and to hold an unlimited amount of it. Only if this is possible, can the central bank exert any pressure on the structure of interest rates, and the availability of credit by using the "traditional" tools of monetary policy.

In some developing countries, e.g. some of the Dominions, central banks were established with the authority to rediscount a certain class of bills. But as there was no bill or short-term money market, the central bank was not used as a lender of last resort and its powers proved useless. In other countries there is an active market for a certain type of short-term paper, but of a kind which is not acceptable to the central bank. This is the case in Lebanon where, as will be explained later, banks hold a lot of what is called accommodation paper, which is not rediscountable at the central bank. Finally, it may also happen that although there is an active short-term money market, banks do not have much recourse to the central bank except in emergencies because there is an alternative way of liquefying their assets. This is the case when banks tend to offset among themselves the surplus funds they hold over the demand for them. When that happens the money market becomes in normal times the effective lender of last resort. This point is very important for our later discussion on the Lebanon, and for developing economies in general; a lender of last resort is not always what is lacking in an economy as seems to be implied in the creation of traditional central banks. From this it follows that monetary control which is based on the role of a central bank as a lender of last resort can be inadequate, and if it is not to be a lender of last resort, a central bank will need a direct link with the money market: this link can be provided for example by its commercial banking business. It will be useful to illustrate this and discuss two examples of money markets becoming lenders of last resort. These can be found in the monetary histories of the United States of America and of France.

The Federal Reserve System dates back only to 1913. Until then there was no central banking institution in the United States, although banking had been subject of two important pieces of legislation.[1]

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1. The Free Banking Act of 1833 adopted by the New York State and the National Bank Act of 1863. The first one influenced subsequent American banking requirements regarding the organisation of banks. In the second Act the Federal Government again assumed banking jurisdiction after having assumed it twice before by chartering the first and second Bank of the United States (1791-1811, 1816-1836). It provided a national currency and regulated the banking profession. For details see: Wright, C.W., Economic History of the United States, McGraw-Hill Co. Inc., University of Chicago Press, 2nd edition, 1949, pp. 376, 444-445, 671-676.

However, it had sometimes proved necessary to improvise to make up for the absence of such an institution, and it is precisely these improvisations and their limitations that made the need to establish a central banking institution really felt. The improvisation that is of interest to us in this context is the correspondent relationship that was developed to make up for the absence of a lender of last resort. It started with the need of country banks to maintain balances with banks in financial and commercial centres on which they received interest,[1] and the fact that city banks found it profitable to hold such balances which they could re-invest at a higher rate of interest. The understanding was that country banks could borrow from their city correspondents when for some reason their reserves were temporarily inadequate. Such borrowings took place especially in the summer when farmers, generally the customers of country banks, needed money to finance their crops. This arrangement made it in fact possible to pool the reserves of all the banks and to let the banks work on lower cash ratios. On this basis they offset their surpluses and deficiencies of cash among each other without recourse to a central bank. This correspondent relationship was in fact a form of lender of last resort.

But the arrangement could only work in limited emergencies

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1. Wright, C.W., Ibid. p. 672.

involving a few banks. In effect it only made possible the full use of existing reserves. The co-operation of the banks could not expand reserves when there was a general demand for them from the market. In 1906 these reserves were known to be around three billion dollars[1] and that was all banks of the country had access to. The crisis came in 1907 when there was a general demand for money and the reserves proved inadequate.[2] Banks were reluctant to make advances to each other for fear of needing the reserves themselves and this of course accelerated the pace of the crisis. The inadequacy of the correspondent relationship as a lender of last resort was thus clearly demonstrated and the need for another form of lender of last resort was definitely felt. In 1908 a National Monetary Commission was created by Congress, while the Aldrich-Vreeland Act provided for an emergency note issue to be retired when the monetary stringency ended. General reform came after the appearance of the Monetary Commission's Report in 1912, and resulted in the Federal Reserve Act of 1913 which created the Federal Reserve System and the Federal Reserve Banks, whose "lending power is independent of the funds deposited with them".[3]

1. Board of Governors of the Federal Reserve System, Banking Studies, Washington D.C., 1941, p. 20.

2. For a study of the crises under the National Banking System, see Sprague O.M.W, 'History of Crises under the National Banking System', in Reports of the National Monetary Commission, Washington, 1910.

3. Banking Studies, op. cit. p. 31.

This move gave an elasticity to the currency which was previously lacking. The rise of the Federal Reserve System is interesting as it is a clear example of a central banking institution being created in response to a definite economic need for it and superimposing itself smoothly on the existing banking structure, which it helped to strengthen.[1]

The same phenomenon occurred in France as in the United States in spite of the presence of the Banque de France. Terrel and Lejeune in their 'Traité des Opérations Commerciales de Banques' described the French money market in terms that could be used to describe the American correspondent relationship:

> "banks have come to offset among themselves the surpluses of the supply over the demand for money reaching them, in other words the surplus of their loanable funds over their lendings. Since it is their holdings of commercial bills that are the easiest of their assets to liquify and to transfer, because they are rediscountable, they use them for the purpose of such offsetting. The name 'Marché Hors Banque', or private market, is given to the whole of such business taking place outside the Banque de France".[2]

Thus, although an institutional lender of last resort existed - the

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1. For details of the origin and the early years of the Federal Reserve System see Willis, H.P., "The Record of the Federal Reserve System", in C.F. Dunbar, Theory and History of Banking, New York, 1922, and The Federal Reserve System, one of a series of lectures prepared for the Blackstone Institute, Chicago, Blackstone Institute 1920.

2. H. Terrel and H. Lejeune, Traité des Opérations Commerciales de Banques, Masson & Co. Editeurs, Paris 1926, 5th ed., pp. 172-175. Translation mine.

Banque de France - a money market developed in which the central bank did not operate and on which it could not exert pressure in ordinary circumstances with the traditional weapons. However, unlike the United States, the reserves of the Franch banking sector could be expanded because of the presence of the Banque de France. But once banks turned to it for rediscounting - as one would think they would in emergencies - they were by definition no longer working in the Marché Hors Banque, and the Central Bank could then exert any pressure it wanted by the traditional tools of monetary policy. The Banque de France is necessary because by itself the Marché Hors Banque cannot expand the reserves at the disposal of the banking sector: it only makes for a better use of them.

The American and French experience just described is useful when one comes to consider developing economies. First, it draws one's attention to how it may be possible for traditional tools of monetary policy not to work. In effect these rest on the assumption that banks often resort to the central bank for funds.[1] If they do not, these tools cannot be effective. The American and French experience shows us that there may be an alternative lender of last resort in an economy that can be totally independent of the central bank. If this is the case, the traditional powers of the central bank might well prove inadequate.

Now it is often the case that in developing economies foreign

1. See below where reserves requirements are discussed.

banks are very important relatively to local ones. They have access to practically unlimited funds from their head offices or branches in other countries and thus are totally independent of any traditional central banking action including variable reserve requirements. Special legislation regulating their import of funds could be introduced to enforce the traditional tools of monetary policy, but such legislation may not always be desirable, and thus other measures may have to be adopted. As regards local banks, if there is no active money market, they tend to keep high cash ratios, so that any traditional central banking action would take a long time to be effective, if at all. Thus, for example, in Iraq in the early 1950's, banks kept high cash ratios and it was reported that this

> "serves to explain the fact ... that the commercial banks have had no need to resort to the National Bank for borrowing... the banks may face a very considerable expansion of their lending operations before they become dependent on the central bank for additional cash".[1]

In such circumstances, a case can be made for the use of reserve requirements. But if, at the start, the same reserve ratios are not generally kept - as is very likely in underdeveloped countries - it would be difficult to impose specific reserve requirements without causing considerable hardship and strain on some banks - which may be

1. Iversen, C., A Report on Monetary Policy in Iraq, National Bank of Iraq, 1954, p. 28.

harmful - while leaving others relatively unaffected. Such situations would call for different measures of control depending on the peculiarities of each country.

Another point to notice from the American and French experience is that unlike the Bank of England, the Bank of France and the Federal Reserve Banks continue to engage in commercial banking, which is denied to the majority of new central banks. This is an illustration of the point that here again there should be no general rule.

Before concluding this section there are two points that should be made with regard to using the central bank as the government bank, and to check the activities of commercial banks.[1] These functions have become traditional in central banking practice. When the central bank is the sole custodian of the government's funds it removes one very effective means of credit control. By increasing or decreasing the proportion of funds held with the commercial banks - or with the central bank - the public authorities, who could act on advice from the central bank, can expand or curtail the base of the credit

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1. The notable exception is Belgium where a Banking Commission performs that job. It is composed of a President and five members, one being a director of the National Bank of Belgium (Central Bank), two appointed from a list presented by the banks, and two appointed from a list presented by the National Bank and the Institute for Rediscount and Guarantee.

pyramid and thus the volume of credit. This measure could be useful in developing economies where it is intended to encourage commercial banks in their activities and to keep them under control. It is also useful when other methods of control are not very effective, for the authorities can use it in the same way as open-market operations when these are not possible through lack of a proper money market. This method was used on and off in the United States until the establishment of the Federal Reserve System in 1913.[1]

Finally, central banks are sometimes thought necessary to prevent the commercial banks becoming illiquid and insolvent. A constant watch on their balance sheets is supposed to achieve that aim. Although this could be an important contribution of the central bank, it is not a very important argument in deciding whether or not to create a central bank in a country. In effect, banking sectors have in their clearing houses a sort of built-in control, for the position of each bank is known to the others and any signs of illiquidity or insolvency is immediately noticeable.[2] If however the clearing house is not an adequate check, a banking commission can be formed by the Government to look into the balance sheets of the banks.

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1. For details of the operations and the attitudes of the different Secretaries at the Treasury see Banking Studies, op. cit. pp. 21-25.

2. This is known to have been a powerful check on American banks before 1913.

The purpose of this section is to provide a background against which the problem of central banking in Lebanon could be approached. The role of a central bank is by no means the same in all countries, nor is there an eternal set of rules they can all follow. The fashion of central banking has often blinded people to the particular requirements of the countries in which they were being established, and this has resulted in ill-adapted central banks. When deciding whether or not to establish a central bank and what role it would fulfil, the question to ask should be, what would this institution do that would be required by the economy, rather than, has the country a central bank or not? There would then be a much better chance of establishing a central bank that could genuinely contribute to the development of the economy.

In the early 1960's Lebanon had to face the problem of whether or not to establish a central bank as in March 1964 the charter of the note issuing bank, the Banque de Syrie et du Liban (BSL), a private and foreign-owned bank, expired.[1] The decision was finally in favour of a state-owned central bank which started its operations on the first of April 1964, and which is described in the following section.

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1. Details of the BSL's activities will come in Chapter V.

II. The Bank of Lebanon

The charter of the Bank of Lebanon was drawn up in the Law of 1st August 1963, which promulgated what is called the 'Code de la Monnaie et du Crédit',[1] which will be referred to as the Code.

The Bank is created by Article 12. Its general purpose is to safeguard the value of the currency with the view of furthering the economic and social progress of the country (Art 70). Its capital is £L 15 million entirely subscribed by the State (Art 15). A Governor, three deputy governors and a Central Council run the Bank. The Governor is appointed by the Government for six years and on the proposal of the Minister of Finance (Art 18). The Deputy Governors are chosen by the Government but on the proposal of the Minister of Finance and the Governor, and for five year terms. All terms of office are renewable. Strict conditions regulate the removal from office of the Governors and his deputies, who should relinquish all other posts while at the Central Bank (Art. 19-27).

The Central Council is composed of the Governor, who presides, two deputy governors, and the directors-general at the Ministry of Finance and the Ministry of National Economy (Art 28). The general policy of the Bank is decided upon by the Council (Art 33). In

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1. Bill promulgated by decree No. 13,513 of 1st August 1963, which appeared in the *Journal Officiel* No. 62, on 5th August 1963.

particular, it fixes the discount rate of the Bank, and it decides how best to control the volume of credit. The various ways by which this may be done are described in Articles 76-79 and 175: the Bank can vary its rediscount rate, impose a ceiling on rediscounting, operate in the open market for bills, and vary the banks' reserve requirements - to be kept at the Central Bank - which however should not exceed 25% for sight deposits and 15% for time deposits. The Bank is also empowered to restrict hire purchase credit (Art 79) and to fix and alter cash and liquidity ratios (Art 175). Commercial banks are finally asked to submit their positions monthly to the Central Bank (Art 146).

The Central Council decides on matters relating to note issuing. This activity is regulated by Articles 47-69. In particular, a minimum gold cover of 50% is required for the currency. It also decides on matters relating to the other operations of the Bank: transactions in the gold market, dealings in foreign exchange and co-operation with other central banks (Art 81). It should be noted in this context that the Bank is not allowed to do any ordinary commercial transaction with the private sector (Art 82). Its banking business can be performed with the public and banking sectors only.

In all its decisions, the Central Council will be helped by a

Consultative Committee of six members which will report to the Governor (Art 35-40). The banking, commercial, industrial and agricultural sectors will contribute one member each, the fifth member being from the Planning Council, and the sixth a professor of economics. The term of office is two years but it can be renewed indefinitely. The Committee has advisory powers only and can give advice when asked by the Governor (Art 38) or when it deems it necessary and useful (Art 39.).

The Bank is the sole custodian of the public authorities' funds (Art 85), and it can advise the Government on various measures it thinks desirable to adopt (Art 72). In accordance with the instructions of the Minister of Finance it will intervene in the foreign exchange and gold markets to assure their stability. However, it will only be able to deal in foreign exchange convertible into gold (Art 75). Regarding the problem of lending money to the public sector, it is explicitly mentioned that the principle is that the Central Bank does not grant credits to the public sector (Art 89). However, the Bank is authorised to grant the Government overdraft facilities repayable after four months with amounts not exceeding 10% of the average fiscal receipts over the previous three years (Art 88). Furthermore, in 'exceptionally grave circumstances' the Bank, after having studied all other alternatives, is allowed to grant a loan to the Government. Similarly it is allowed to grant loans to other public agencies but in all cases they have to be repaid within ten years (Art 91-92). The rates charged will be the market rates (Art 93). Finally the Bank will help the State in issuing bonds or bills and will manage the public debt (Art 97).

The Bank will also act as a bankers' bank by allowing them to keep accounts with it (Art 98), and by rediscounting their ninety day paper bearing three first class signatures (Art 100). It can also offer them the 'en pension' facility, whereby the Bank discounts the paper on the understanding that the commercial banks will buy it again within a month (Art 101). Finally, it may grant them credits not exceeding twelve months and against the security of first class commercial paper, gold, foreign currencies or shares (Art 102). The Bank's holdings of public securities whether as a result of rediscounting or of guarantee for a loan should never exceed the amount of the capital of the Bank (£L 15 million) and its reserves - accruing from profits - (Art 108). The maximum life of ninety days required of a commercial bill to be eligible for rediscounting applies to public securities also (Art 106).

The control of the banks posed many problems because of the Banking Secrecy Law[1] which bankers were eager to preserve. The original draft

1. The Banking Secrecy Law of 1956 makes it an offence to divulge information about the credit accounts of depositors. Details are given in Chapter II.

of the code had stipulated that inspectors from the Central Bank would be able to call at any time at the banks and consult their registers. Although the inspectors would respect the Banking Secrecy Law, the employees of the banks would not be able to cite that Law as a justification for not submitting certain information. This provision was bitterly opposed and fought by the Association des Banques du Liban (ABL) which emphasized the importance of the Law in the Lebanese economy and the need to keep it as it is.[1] The ABL suggested instead that a banking commission composed of representatives of the commercial banks, of the Central Bank and of the Ministry of Finance be formed to which banks would send their statements.[2] This proposition was rejected, and the compromise was that a department totally independent of the other departments of the Central Bank and attached directly to the Governor would inspect the banks' statements; but on no account can the inspectors ask for details of crediting accounts, nor can they meet anyone but the director of the bank concerned (Art 148-151).

This is the first time in their history that Lebanese banks have been subject to any sort of control.[3] However, the Code does not

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1. Information gathered from the minutes of the meetings held in April 1963 between the Conseil de la Monnaie et du Crédit and the ABL. These minutes were privately secured. See Appendix for the importance attached to the Banking Secrecy Law by the ABL.
2. This is the practice in Belgium.
3. Details of this will come in Chapter II.

simply create a watch-dog for them. It goes further by laying down a set of rules within which banks have to operate. Previously their business had been totally unregulated. Thus, opening a bank needs now the approval of the Central Bank (Art 128), and the minimum capital allowed is £L 3 million (Art 137).[1] Originally, it was intended that there should be two classes of banks, one specialising in short-term credits, and one in long-term credits. But here again the ABL fought hard on the grounds that no suitable and clear criteria for distinguishing the two classes of banks were laid down, and the idea was dropped.[2] Instead it is simply mentioned that banks must match their assets with their liabilities (Art 156).

Banks are forbidden from running any other business than that of banking proper. Their participation in any sort of enterprise together with all their real estate investments - including their offices - cannot exceed 75% of their own funds, i.e. their capital plus their reserves (Art 153).[3] They are not allowed to grant loans to their Boards of Directors, nor to their executives nor to the relatives of

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1. This is no more than a compromise figure, the first draft asking for a minimum capital of £L 5 million and the ABL insisting that £L 1 million was enough.

2. Information gathered from the minutes of the meetings held in April 1963 between the ABL and the Conseil de la Monnaie et du Crédit. The minutes were privately secured.

3. This provision is identical to one made in France in the 1945 Banking Law, amended in 1946.

these people, unless these loans are approved by the General Assemblies of shareholders (Art 152).[1] Finally before agreeing to a loan a bank must ask for a detailed balance sheet from the borrower, including individual persons (Art 160), and all agreed loans, whether used or unused must be communicated to the 'Centrale des Risques' run by the Central Bank (Art 147). The information is pooled and then sent out to the banks - which pay for the running of the 'Centrale'.[2]

The control of the activities of the Central Bank itself is assured by a 'Commissariat du Gouvernement auprès de la Banque Centrale' which is part of the Ministry of Finance (Art 41). The functions of the Commissariat are to see that the law is properly followed, to check the Bank's accounts and to report to the Minister of Finance (Art 42, 44, 45). It must be kept informed of all the Bank's decisions and it has the right to stop their implementation within two days if they are contrary to the Law (Art 43). It is not clear whether commercial banks will be able to complain to the Commissariat when they think the Central Bank has infringed the law. If this should develop the Commissariat will be a sort of ombudsman of the banking sector.

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1. As will be shown in Chapter II, a few banks were created by people because they could not acquire credits in other banks. That was common in the United States. See reference Chapter II, p. 55. This measure could not really be taken as a protection to the depositor because the shareholders are still usually few and tend to be themselves the Directors and executives of the banks. See Chapter II, p. 61

2. The 'Centrale des Risques' is described in more detail in Chapters II and V.

The Code de la Monnaie et du Crédit has created a Central Bank in a country where the business of banking - as will be shown in the next chapter - was totally unregulated save for the Banking Secrecy Law of 1956. It has created a Central Bank in a country where - as will be explained in Chapter III - laissez-faire has been the creed of the people. If one accepts the assertion that the essence of central banking is discretionary intervention in the monetary system of a country, the establishment of the Bank of Lebanon is tantamount to a reversal of previous policies. Was a change from the previous system necessary, and is the new Central Bank well adapted to the requirements of the country? The following chapters examine the commercial banking sector and the expected future credit requirements of the Lebanese economy. In view of these requirements, the important functions that could well be served by a Central Bank are discussed in Chapter IV. Finally Chapter V discusses whether or not the Banque de Syrie et du Liban could have fulfilled the role ascribed to a central bank in Chapter IV, and whether or not the new Central Bank, the Bank of Lebanon, is able to fulfil it.

APPENDIX TO CHAPTER I

The importance of banking secrecy as seen by the Association des Banques du Liban

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In view of the importance that the Banking Secrecy Law of 1956 seemed to have had in the setting up of a mechanism for the control of the banks, it may be interesting to reproduce here a letter sent by the Association des Banques du Liban (ABL) to the Prime Minister who in 1963 was also Minister of Finance and therefore ex officio President of the Monetary and Credit Council which was preparing the new banking law.

In a previous letter to the Prime Minister dated 12th February 1963, the ABL had stressed that there should be no question of changing the Banking Secrecy Law of 1956 which apart from the Code of Commerce, was the only law applying to banking. That law had proven its worth in 1956, 1958 and 1961 when political troubles would have caused massive withdrawals of deposits. The letter pointed out the necessity for Lebanon to offer such banking facilities, which necessity is caused by the very position and smallness of the country.

The same letter then put forward a plan for having two separate pieces of legislation, one dealing with "the currency" and the Central

Bank, and the other with the "organisation" of the banking profession. The basis for this distinction is that the privilege of note issue is one of the features of "national sovereignty that belongs to the State alone, and the Central Bank is a governmental body", whereas the organisation of the banking business deals with a "free profession owned by private bodies". For this reason, the control of the banking business could only be built on this distinction, and so, two bodies were required. Finally there follows a comment on various articles of the Law.

The second letter reproduced here in full was sent in March 1963.

Your Excellency,

You very kindly referred to the Lebanese Banks Association the projected monetary and credit law prepared by the Monetary and Credit Council, asking it to consider it and to comment upon it.

The projected law was distributed to all members of the Lebanese Banks Association, and was subject to various comments and memoranda from the said establishments. It also underwent verbal discussions in numerous meetings arranged by the different bodies of the Association.

As a result of studying the project which you kindly referred to us, we were honoured to give you a preliminary report on 12th February 1963 in which we put forward our points of view and our comments on the establishment of the Central Bank.

In the report, we pointed out to your Excellency that the banks see that in the foremost it was preferable that the project should be tackled with two independent laws appearing together or consecutively. The first one would deal with the currency and the Central Bank, and the second one with the organisation of the banking profession.

Our letter of 12th February 1963 explained the reasons that led the Banks' Association to suggest this course. These reasons are not concerned merely with the form: they are fundamental to all the resolutions that are subject to discussion.

We added also that regarding the second law, i.e. the law regulating the banking profession, the Banks' Association pledges itself to put forward its suggestions on it, if your Excellency asks for them. And we did emphasize then our readiness to send forthwith the second part of the suggestions if and when we were asked to do so.

In your letter of 28/2/1963 we were informed that the Government does not share the opinion that the projected law should be split into two independent laws, the first one dealing with the currency and the Central Bank, and the second one with the regulation of the banking profession.

At the same time you kindly included new amendments to the first project which you had already sent us. These amendments embodied fundamental changes regarding the regulation of the banking profession. As a result we were forced to revise our comments on the part that deals with those regulations. But for that we would have sent the following comments immediately on receipt of your letter.

Your Excellency,

The Banks' Association's memorandum had included the reasons that led it to give the first advice which is the division of the projected law into two independent laws.

It also included a very clear offer to study the regulation of the banking profession to arrive to a law that can be adapted effectively to the requirements of an economy that is as structurally complicated and original as that of Lebanon. In all frankness that was our aim.

The failure to produce any explanation for refusing to split the law into two laws that could be passed concurrently or consecutively leads us to reemphasize the desirability of such a course, which we had explained in our previous memorandum to you, and by which we still stand.

The second advice, namely, the respect of the Banking Secrecy Law when it comes to controlling the banks, is something essential for the Banks' Association. The foundations of the control mechanism as it emerges in the two projects you submitted are in direct conflict with Article 2 of the Law of 3rd September 1956.

That Law did not create banking secrecy as a privilege to be enjoyed by the banks but as a duty the banks must observe, not just for the benefit of the banking profession, but more specifically for the interest of the public and of those who deal with banks.

The duty of the banks to preserve the secrecy that is imposed by Law, for the benefit of their clients makes it imperative that details about their clients are known to the directors of the bank only.

If such details were known to people outside a bank and not part of the Board of Directors, as would be the inspectors of the Central Bank, effective professional secrecy and responsibility would be lost. Thus would result in a crisis of confidence among the people who have used banking secrecy in their interests.

Had the Banking Secrecy Law been no more than a privilege granted by the Legislature to the banks, it would have been possible to reduce its scope to a certain extent. But, and we repeat it again, the case here is that of a duty imposed by the Legislature on the banks and the contravening of which is severely punishable; this duty was imposed in the interest of the general public and of the depositors. As a matter of fact the law is the privilege of Lebanon.

In which case, any measure aimed at weakening the idea of banking secrecy is in contradiction with reality or even a straight cancellation of the law that imposed professional secrecy on the banks. That law was the one that fixed the present economic organisation of the Lebanon and that constitutes one of its main structural parts.

The effects 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; and, things being what they are, it is not possible nor can it be thought of touching the rights of those who have trusted us. That trust has increased our economic resources and has contributed to our development and prosperity.

Therefore, the Lebanese Banks' Association consider that any attempt, even if indirect or separate, to touch the Banking Secrecy Law is an attempt to change the foundations of our economic system, of our future wealth and of the well-being of our people.

And considering that some sort of control is necessary and useful, it is imperative that clear cut measures are taken to ensure that the names of people protected by the Secrecy Law, do not show up at all.

This is the most important provision that should be adopted in any control mechanism whatever form it may take.

In its previous memorandum, the Banks' Association had indicated a way worth considering and that would, thanks to its very nature, ensure the provision above-mentioned.

If it is possible to go further in the discussions, the Association is prepared to take part in such talks with the people responsible for the matter, in order to find a way that is acceptable and that is adapted to the principle of banking secrecy.

Finally before we move on to the comments on the texts, we should like to refer to the fact that the project ignores the professional organisation that exists [The ABL] and which could be called upon to co-operate to reach the goals pointed out in the legislation. This role of such organisations is recognised in the legislations of a great number of countries that have great experience in the field of banking.

Therefore, Your Excellency, we allow ourselves to reiterate our suggestion that a meeting or a series of meetings be arranged before the final texts go to the Council of Ministers.

Awaiting your invitation to the meeting we present our deep respects.

The President of the Lebanese Banks'
Association,
Pierre Edde

Meetings between the Banks' Association and the Government were arranged, the first one being on 21st March 1963. At the first 3 meetings were present the Minister of Finance, the members of the Monetary and Credit Council, a delegation of the ABL and a representative of the Issuing Department of the Banque de Syrie et du Liban. All the points subject to dispute were discussed, but important decisions were taken in the fourth meeting when only the Minister of Finance and Mr. Paul Klat (of the Monetary and Credit Council and himself a banker) representing the Government, Mr. Pierre Eddé (President of the ABL) and Mr. Alexander Sara (Counsellor to the ABL), representing the banks, were present. The fourth meeting was held on 2nd April 1963.

The ABL did not succeed in splitting the legislation but won many concessions regarding the control of the banks and their organisation. Its position was considerably strengthened as a result.

CHAPTER II

COMMERCIAL BANKING IN LEBANON

This chapter starts with a rapid survey of the development of commercial banking in Lebanon. Then follows a description of the activities of the commercial banks and a consideration of their liquidity position. This will be useful for a later discussion on financing economic development in Lebanon.[1]

It is important to note from the start that all the statistics that will be used are very approximate. The only official source is the Banque de Syrie et du Liban (BSL) until March 1964, and the Banque du Liban (Central Bank) thereafter. Other sets of statistics do exist but they were compiled privately, and where they differed from the BSL ones, no indication was given as to why this should be the case. That is why the official sources only are used. More detailed statistics were obtained through an official monetary institution which we cannot cite. Where that is the source it will just be mentioned that the information was privately secured.

I. Development of Commercial Banking in Lebanon

The Lebanese banking system provides for a country whose area is 23 times smaller than that of Britain and whose population amounts to

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1. In Chapter IV.

a mere 2 millions. But its strategic position on ancient trade routes, its particular position in the Middle East context, and the energies of its people have combined to give it an economic importance quite disproportionate to its size. Thus it was said:

> "Lebanon's greatest economic advantage lies not in its natural but in its human resources. The inhabitants of this coastal range of mountains have been traditional sailors from ancient times, and through their migrations have kept contact with growing civilizations. This outgoing disposition made easy, during the last century, an early contact with modern Europe which gave Lebanon a lead in the adoption of Western education and led thus to a higher level of education, greater skill and more versatility among the population than can be found in other parts of the region."[1]

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 XIX Century. But these were mostly foreign both in capital and in management. They financed foreign trade, leaving domestic trade to the few and small local banks and discount houses. The most important foreign bank then was the Imperial Ottoman Bank incorporated by Royal Charter, and which had British and French capital. It assumed great importance and this led the Turkish Government to recognise it as the state bank which would deal with the Treasury. It had branches throughout the Ottoman Empire but the most important one was the Beirut branch.

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1. F.A.O. Development Project, Lebanon, Country Report, Rome, 1959 Chapter I, p. 2.

The other foreign banks operating in Beirut were the Deutsche Palestina, the Deutsche Orient Bank and the Banque de Salonique.[1] The first two were German, established respectively in 1889 and 1906. The third was controlled by the French Société Génerale to start with, and then by the Crédit Foncier d'Algérie et de Tunisie, which still operates in Lebanon.

It is not possible to have details of the activities of local banks and discount houses, as no information to this effect is available; but it is reported[2] that their main customers were merchants - presumably for internal trade - and landowners. Thus when the First World War broke out, the banking sector in Lebanon was still in its embryonic stage. Credit to farmers or industrialists was practically non-existent.[3] Industry was still very unimportant in the country and agriculture still occupied 75% of the population. When in need of funds the farmers had to resort to money lenders who charged very high rates of interest, sometimes reaching 50% per annum.

When it broke out, the First World War killed the embryo that was developing. With the defeat of Turkey and Germany practically

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1. Himadeh S. B., Monetary and Banking System of Syria, American Press, Beirut 1935, p. 30.

2. Toak J. W. J. Monetary and Banking Developments in Lebanon. M.Sc.(Econ) thesis at the London School of Economics and Political Science, Typescript, 1960. Information received from private interview with Professor S. B. Himadeh of the American University of Beirut.

3. There was one agricultural bank for the whole Ottoman Empire and it had agents in the main cities. But it only lent against real estate or movable property and not against crops.

all foreign banks in Lebanon had to close their doors. A fresh start had to be made. The initiative came now from France. The Banque de Syrie et du Liban, a French institution, took over the functions of the former Imperial Ottoman Bank while other French banking institutions established branches in Lebanon. Banks from other countries followed the French example and shared a thriving commercial banking business. One bank - French - the Crédit Foncier d'Algérie et de Tunisie, specialised in mortgage credit. Alongside the opening up of branches of foreign banks, new Lebanese banks were established. These started operating in the late twenties. The most important were the Banque Robert Sabbagh and Co., Banque G. Trad and Co.[1] and Banque Misr-Syrie-Liban.[2]

Looking back over this period between the wars, it seems strange that local banks could survive and prosper alongside foreign banks with formidable resources and experience in the monetary field. To understand how they managed it, we might quote Professor R. S. Sayers on the subject of banking in an economy:

> "A banker has two main functions: he is part of the capital market linking lenders and borrowers, and he at the same time provides a means of payment .... In a new field the success of the banker as a provider of means of payment depends upon his success as a lender and borrower; and his success as a lender and borrower likewise depends upon his success in providing a means

1. Now known as Banque G. Trad (Credit Lyonnais) S.A.L.

2. Later renamed Banque Misr-Liban.

of payment. The two aspects of his business are inter-dependent.... Because of this interdependence, banking cannot be regarded as the automatic functioning of a money machine. The progress of a bank depends, more than anything else, on the relations developed between borrower and lender - whether the bank is the borrower and the customer the lender, or vice-versa. Banking is thus conditioned by the general economic structure, especially in the readiness with which property, in goods, lands and other assets, lends itself to the creation of security for loans. But everywhere and all the time it is a matter of relations between banker and customer and the detailed background of their everyday business".[1]

This quotation sums up well why local banks prospered alongside their foreign competitors, for it is particularly true of the Lebanon that the progress of a bank is "a matter of relations between people". There are two reasons for this, and they are worth considering:

(1) Lebanon is a very small country and the business and financial community is even smaller; personal relationship is made much easier by the fact that people know each other. Furthermore, when local banks were first established, their customers were mainly merchants and landowners who would know the banker and would be known by the banker.

(2) The banker himself was usually a successful businessman who considered that having a bank of his own would crown his career.

1. Sayers R. S., ed. Banking in the British Commonwealth, Oxford, the Clarendon Press, 1952, 'Introduction' pp. vii-viii.

Banking had certainly some appeal to the people. The fact that he was in business before opening his bank made him known to the people who would actually use the bank. It was certainly true - and still is - that people used one bank rather than another not because the performance of that particular bank was good,[1] but because the names associated with it were known to them. Most banks started as private firms and usually bore the names of their founders. Thus, people had personal contacts and connections with local bankers, which they did not have with foreign bankers. This encouraged them to place their funds with local bankers and to deal with them.

Furthermore, the quotation above rightly says that banking is "conditioned by the general economic structure, especially in the readiness with which property in goods, land and other assets, lends itself to the creation of security for loans". In the case of Lebanon, real estate was the chief tangible asset of most people and lending against such a security was quite common as it was considered to be the safest. Foreign banks were reluctant to make this type of loan

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1. In any case no regular balance sheets were published.

while Lebanese bankers knowing better the local customers, assessed with more confidence their credit worthiness and were prepared to accept real estate as a security for loans. As there was no legislation to regulate the banking business, it was left entirely to the discretion of the banker whether or not to grant a loan and on what security. With so much being left to his initiative, his credit as a banker was established not only with the public, but also with foreign banks. This is where the relations local bankers had with the people became important. For, funds being limited, local banks had to compete for them by offering high rates of interest on sight deposits. But foreign banks had access to large funds, part of which came from their head offices. They had no intimate knowledge of the customers' credit worthiness and were not ready to accept real estate as security for a loan. So the Lebanese banker stepped in: he borrowed the money from the foreign banker, giving him the kind of security he liked to have, and lent the funds thus acquired to his customer against the security of real estate. This must have been the origin of the highly developed Lebanese 'Marché Hors Banque' which will be described later in the chapter. Thus from both sides - the foreign banks' and the people's - factors favourable to the growth of local banks were at work.

After the Second World War, the banking sector in Lebanon grew at a pace which made the Governor of the new Central Bank later "wonder sometimes whether it has not been too rapid".[1] Many factors accounted

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1. Governor Takla's speech at the Rotary Club dinner on 25th May 1964, reported in L'Orient, of 27th May 1964.

for its prodigous growth:

1. Laissez-faire

There was no restriction whatsoever on the opening up of new banks, and no legislation regulated their work. The business of banking was considered an act of commerce. Indeed the 'Code de Commerce' which regulated all commercial business applied also to banks. No rules governed minimum reserve ratios. Banks were not even asked to produce regular balance sheets.[1] This total freedom certainly made things much easier for anyone to open a bank.

Furthermore, and as a consequence of this total freedom, the same phenomenon that took place in the United States in the XIX Century was apparently taking place in Lebanon. In the period 1816-1860 in the United States 'the organisation of banks .... was often owing not simply to the need of some community for the facilities provided thereby but also to the wish of the organisers to secure the means for financing some of their own enterprises. Thus Secretary of the Treasury Crawford writing in 1820 said that most of the banks started after 1812 were organised

"... not because there was capital seeking investment, not because the places where they were established had commerce and

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1 The Law of 1959 instituting the Monetary and Credit Council had stipulated that the banks should submit regularly to the Council statistics to enable it to carry out its duties. The Association des Banques du Liban pointed out that the Council not being a banking institution could not have access to such information without contravening the Banking Secrecy Law. That was accepted by the Council of Ministers and a Law on 18th September 1961 altered this provision and said that the statistics would eventually have to be sent to the Central Bank. The banking profession remained thus unregulated.

manufactures which required their fostering aid, but because men without active capital wanted the means of obtaining loans which their standing in the community would not command from banks or individuals having real capital and established credit".'[1]

In Lebanon it was not so much perhaps the case that banks refused credit to unworthy borrowers as the fact that these men who wanted credit thought they could get it on better terms - and make a profit - if they opened their own banks. After all, they could run it the way they chose. This factor certainly accounted for the opening of not a few banks.

Laissez-faire also encouraged and gave confidence to foreign banks to open branches in Beirut. The Middle East is important from the point of view of finance, and Lebanon seemed one of the safest places - politically and economically - for foreign bankers to work from. Thus among others, American (Bank of America, First National City Bank of New York, Chase Manhattan Bank), British (British Bank of the Middle East,[2] Eastern Bank Limited), French (Banque Nationale pour le Commerce et l'Industrie, Crédit Foncier d'Algérie et de Tunisie), Italian (Banco di Roma), Dutch, Belgian, Canadian, Russian and Arab banks opened main offices in Beirut. Some banks preferred partnerships with local banks: the

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1. Wright, C. W. Economic History of the United States. McGraw-Hill Book Co. Inc. 2nd Edition, 1949. pp. 371-372.

2. Now a member of the Hong Kong Bank Group.

Credit Lyonnais of France with Banque G. Trad S.A.L.; Others have just representative offices; this is very common with German banks.[1] The representative offices differ from the others in that they deal with documentary credits and investment only. This fact stresses and proves the importance of Beirut as a trade centre. This brings us to our next point.

2. Geographical position of the country.

Beirut is at the doorstep of the Middle East, a developing region of the world vital for its mineral resources. The Lebanese always kept close commercial contacts with the West and the Arab world, and thus channelled Middle Eastern trade with the West through Beirut.[2] This necessitated a great expansion of the port of Beirut and the growth of ancillary activities. Among the latter were banking activities.[3] The importance of this trade sector is readily seen from national income estimates: in 1962, 32% of the national income was derived from trade alone,[4] thus making this sector the largest contributor to the national income.

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1. The Dresdner Bank, the Commerz Bank, and the Bayerische Vereinsbank among others have representative offices in Beirut. Some American banks have recently opened representative offices: Morgan Guaranty Trust Co., Bankers' Trust and Irving Trust.

2. See, for example, I.B.R.D., The Economic Structure and Credit Worthiness of Lebanon, Washington, D.C. 1952 (Typescript).

3. For a comparative analysis of the growth of commercial banking in the Middle East, see Ali, A., 'Banking in the Middle East', IMF Staff Papers, Vol. 6 1957-58.

4. See Chapter III pp.124

Transport and communications with the rest of the world were easily and speedily done through Beirut.[1] Thus beside being in a politically stable country and being an agreeable place to live in, Beirut was the most convenient city for foreign banks to choose to open a branch.

3. Abundance of Capital

There are about 2 million Lebanese people living outside the Lebanon. They had left Lebanon to find work and have usually established prosperous businesses abroad. Every year they repatriated large amounts of money often used either to open a new bank or to contribute to the capital of an established one.[2] A steady flow of deposits into the banks was created as repatriation of funds took place.

Besides the emigrants' repatriation of funds, capital was also provided by Arab nationals and especially those of oil-producing countries. The reason they chose Lebanon as a haven for their capital was that among the Arab countries[3] Lebanon is one of the

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1. These facilities were not available to the same extent in neighbouring countries.

2. For example, the Banque Libanaise pour le Commerce, S.A.L., and the Bank of Lebanon and the Middle East S.A.L. Rough estimates of how much are repatriated are available for 1954-57.

	L.L. millions
1954	58.4
1955	79.5
1956	87.5
1957	95.1

Source: Paul Klat, Economics Research Institute, American University of Beirut, 1958.

3. The common language and the proximity were the reasons for preferring an Arab country.

most stable countries politically speaking and has had total and free convertibility since 1950. Furthermore, the economy was expanding steadily and Lebanon was the only country in the Middle East able to boast a 90% gold cover to the currency. As will be explained later this was an important factor in encouraging the inflow of capital.

Finally what encouraged people from all over the Middle East to deposit money in Lebanon rather than elsewhere was the Banking Secrecy Law of September 1956. Article 2 of the Law stipulates that bank employees and managers are forbidden to divulge the names of their clients, or to give any details pertaining to their holdings or their activities, to any private person or administrative judiciary or military authority. They can only do it if they have the written consent of the client, if the latter has gone bankrupt or if there arises a dispute - within the context of banking - between the bank and the client. Furthermore, numbered accounts are permitted and this guarantees the complete anonymity of the client. Article 8 of the Law makes it an offence punishable by imprisonment to contravene the Law. Any complaint is followed by public action against the bank.[1]

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1. Switzerland is another country where banking secrecy prevails. But it is not a law as in Lebanon. It is an agreement on the scale of the 'cantons', i.e. the Federal Government can force a bank to divulge details on certain deposits. In Lebanon it is a law the contravention of which is punishable.

In the Middle East context this Law was bound to attract capital in need of haven. Moreover, it must have encouraged Lebanese people to keep their precautionary cash balances in Beirut and not abroad, as used to be the case.

The success of the Law in attracting foreign money was partly due to the interest rate policy of the commercial banks. As we shall see later in this chapter, high rates of interest are paid on sight deposits. Therefore not only complete secrecy surrounded the identity of the depositor, but he was able to receive interest on his deposit and to withdraw it without notice.

4. <u>Internal developments encouraging the growth of banks</u>

In addition to those already mentioned one can add the readiness with which the Lebanese people accepted to use banking facilities. Thus in 1951, 45% of the total money supply - sight deposits plus currency circulation - consisted of notes. In 1962, the proportion was nearly halved and stood at 25%. The reason behind this is not only the growing confidence people had in the solidity of the banking sector but also the rapidly expanding branch banking system as banks went to the country.

Supply conditions were not the only determinants in the growth of banks in Lebanon. Demand for funds was also important; except for 1958, the economy grew steadily. Its heavy emphasis on trade helped in the development of the short-term credit that this sector required, and "that is why, because of their qualities as intermediaries as financiers and as exchange dealers, banks have naturally found a propitious field for their blossoming and a favourable climate for their expansion in this region made for trade, in this growing country where business is increasingly active, in the midst of an intelligent and cultured population and sheltered by laws guaranteeing the patrimony, the integrity of the currency and the freedom of business".[1]

II The Balance Sheet of the Banking Sector

In this section the activities of the commercial banks in Lebanon are described and, for that purpose, their combined balance sheet is examined. Wherever possible we shall consider the growth of the figures since 1950. Figures before April 1964 were compiled by the BSL and are incomplete in the sense that they do not encompass all the banks. But as they include the largest banks they can still be used for an analysis of the growth of the banking sector. Since April 1964 the figures have been compiled and published by the new Bank of Lebanon (Central Bank). They are comprehensive in the sense that all banks are included. But as we shall see there are still many imperfections in their compilation.

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1. Saadia E, Article in <u>Action</u> (Lebanese Journal) 1955. Translation from French is mine.

1. Liabilities

A. Capital. The total capital invested in banks operating in Beirut - foreign and local - amounts to £L 436.516 million. But that amount is not fully paid. £L 381.220 million had been paid in August 1964.[1] Although local banks are now public companies with limited liability,[2] they are still owned by big shareholders who usually direct and manage them too. This is due partly to the origins of the Lebanese banks described earlier in the chapter, and partly to the unsatisfactory working of the Bourse of Beyrouth where wild speculation - which can be harmful to the clients' confidence in the bank - goes on unchecked.[3] This discouraged many banks from having their shares quoted on its floor. The capital of local banks was provided mainly by Lebanese businessmen, by Arab nationals - mainly from oil producing countries - and by Lebanese emigrants. Until April 1964 there was no minimum capital required for a bank. Since that date a minimum capital of £L 3 million has been required.[4]

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1. Figures applying for August 1964. Source: Banque du Liban (Banque Centrale). (The capital distribution of the banks has been impossible to obtain).

2. That was made compulsory by the 'Code de la Monnaie et du Credit'. Art. 126, the details of which are given in the preceding chapter.

3. More discussion on the Bourse will come in Chapter III.

4. A 3-year period of transition has been provided.

As regards foreign banks operating in Lebanon, the same rules applied: no minimum capital had to be earmarked for Lebanon until April 1964. Since then £L 3 million is the minimum that must be committed to the country.

B. Deposits. Commercial banks in Beirut offer demand, time and saving deposits facilities in Lebanese Pounds or in any other currency. Before April 1964 statistics relating to the banking sector were compiled by the BSL in a very haphazard way. The figures include certain interbank deposits and are not inclusive of all banks. However, they can be used to get an idea of the growth of deposits between 1950 and 1963.

(a) Demand Deposits

In Lebanon, banks compete for deposits by offering high rates of interest even on demand deposits. Rates vary from bank to bank and within one bank from one depositor to another. The rate is often the result of bargaining between the banker and the depositor, but in fixing it the banker will have regard to the amount deposited and to its fluctuations. Rates vary from 2½ to 5%. 7% is sometimes offered but this is rare.

Column 1 of Table I shows the growth of demand deposits in Lebanese Pounds from 1950 to 1963. From £L 232 million in 1952 they rose to £L 1,419 million in 1963. From 54.7%

of the total money supply[1] in 1952, demand deposits were up to 75.2% in 1963. The increase in the proportion was gradual and constant except for the last quarter of 1956 and for the third and fourth quarter of 1958. The political events accounted for the drop in demand deposits in these periods.[2] People ran down their deposits in Beirut, preferring to hoard their money or alternatively deposit it abroad.

The figures given in Table I are yearly and not seasonally adjusted. The reason is that we found no regular seasonal variations in demand deposits. Adjusted figures were on the whole very close and almost identical to actual figures. Where they did vary,[3] political factors were the obvious reasons.

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1. Money supply being: demand deposits plus currency outside the banking sector.

2. In 1956 the Suez War and in 1958 the civil disturbances in Lebanon. Details in the Appendix.

3. Unusual falls were recorded in Novemeber and December 1956 and in the second half of 1958.

TABLE I

DEPOSITS IN LEBANON. IN L.L. MILLION.

End of	Private Demand Deposits (1)	Government Deposits (2)	Time Deposits (3)	Currency Circulation+ (4)
1950	210*	n.a.	6	190
1951	253*	n.a.	6	199
1952	232	73	12	192
1953	219	109	19	195
1954	246	126	27	232
1955	299	67	39	255
1956	307	147	42	320
1957	447	120	50	343
1958	443	132	54	384
1959	621	170	78	385
1960	716	254	113	399
1961	796	303	138	403
1962	971	n.a.	184	440
1963	1,419	n.a.	261	466

Source: I.M.F. International Financial Statistics

* Includes Government Deposits

\+ i.e. currency outside banks.

More detailed figures of demand deposits are available for the period after April 1964. They are now broken down in two figures according to the ownership of the deposit. Thus there are checking accounts - column 2 of Table II - which are defined as "accounts of individuals, accounts that are generally fed by remittances of funds"; and there are current accounts - column 3 of Table II - which represents "professional deposits, accounts fed generally by remittances of bills".[1] No comparison is possible with the figures of Table I for the following reasons:

(1) Figures in Table I include certain interbank deposits which in Table II come under 'Banks and Correspondents'. Interbank demand deposits were not given separately before April 1964.

(2) Certain banks must have included their savings accounts in their demand deposit figures before April 1964 as no separate figures were given for these before that date.

(3) Figures in Table II include deposits in foreign currencies.

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1. Both definitions come from Statistiques Bancaires, Instruction No. 1/62 published by the Lebanese Ministry of Finance. It was the first attempt to standardise the banks' balance sheets.

TABLE II

DEPOSITS SINCE APRIL 1964
IN L.L. MILLION

Month	Saving Accounts (1)	Checking Accounts (2)	Current Accounts (3)	Time Deposits (4)	Banks & * Correspondts. (5)	Misc. Creditors (6)
April	571.1	618.0	660.8	427.5	918.6	389.8
May	606.7	627.8	641.1	408.7	908.3	373.5
June	635.2	619.2	643.1	403.9	994.7	361.1
July	687.9	614.6	624.6	414.3	1,031.5	373.4
August	716.5	611.4	629.7	410.9	1,058.9	288.3
Sept.	735.5	635.6	612.3	400.7	1,074.2	380.3
Oct.	769.6	612.9	618.3	389.3	1,032.5	389.7
Nov.	793	722	614	375	1,057	400
Dec.	835.4	641.3	644.8	387.9	1,098.9	428.7

Source: Bulletin Statistique Mensuel, published by the Direction Centrale de Statistiques.

* These are interbank deposits and include amounts due to the Bank of Lebanon which stood at L.L. 64.3 million in April and L.L. 65.1 million in September. (These figures were privately secured).

Movements of checking and current accounts can be seen in Table II. The drop in the summer may be due to the considerable political uncertainty that prevailed pending the election of a President at the end of August. This caused a slowing down of economic activity, which reflected itself in lower business deposits. Moreover a certain amount of private capital must have gone abroad. Not much more can be said as yet of demand deposits as they are presented now, for we have no adequate series of them. Of especial significance is the importance of current accounts - professional accounts - in the total: they vary around half the total figure, and this is important to remember for later analysis.[1]

(b) Savings deposits or accounts

These deposits are similar to demand deposits in that they can be withdrawn without notice. But they differ in that the holder of the savings deposit cannot use it as a means of payment i.e. he cannot draw a cheque on that deposit. He can only cash it himself over the counter at the bank. This form of deposit is half-way between demand and time deposits. It is immediately available - and thus it is on demand - but

1. The proportion of demand deposits in total deposits is in the subsection on time deposits.

it cannot be used for cheque payments - and here it is like a time deposit.[1]

The similarity of savings accounts and the other two forms of deposits might explain the absence of separate figures for them before April 1964. Some banks must have added them to their demand deposits whereas others left them out of the communicated statistics altogether.

Generally speaking savings accounts receive a higher rate of interest than demand deposits and the interest is free of tax. The rate is higher because these accounts are not expected to fluctuate as much as demand deposits: on the one hand, their administrative costs are thereby lower, and on the other, a smaller reserve ratio has to be kept towards them. Their non-fluctuating character can be seen in column 1 of Table II. Whereas other deposit accounts fluctuated between April and September, savings accounts rose all the time. The very large increase over this short period - over £L 160 million - is puzzling but it may be due to a better compilation of the figures.

1. Theoretically time deposits cannot be used for cheque payments. They can only be cashed by the depositor after he has given the minimum period of notice.

(c) Time Deposits

These usually take one of two forms. Either they are fixed, in the sense that there is a redemption date - three months, six months or one year - beyond which no more interest is payable unless the contract is renewed. Or else, they are withdrawable any time, but with an agreed period of notice.

Rates of interest vary from bank to bank and from customer to customer and are higher than for the other forms of deposits. They vary between 4½ and 6½%. Higher rates are sometimes offered, but this is rather exceptional.

Column 3 of Table I shows the growth of time deposits in Lebanese Pounds since 1950. From £L 6 million in that year they rose to £L 261 million in 1963. The increase was more than forty-fold and larger by far than that of demand deposits shown in column 1. In 1952[1] they were 4.9% of total deposits, while in 1963 they were 18.3%. The increase is substantial but the proportion is still quite low[2] compared to other countries.

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1. We take 1952 because demand deposits figures for 1950 and 1951 include government deposits.

2. There is the qualification however, that figures include inter-bank deposits and we do not know to what extent these swelled one kind of deposit more than the other.

Column 4 of Table II gives data on time deposits from April to September 1964. The great difference between the figures for December 1963 and the figures for April 1964 is due to a wider coverage of banks and better compilation. The proportion of time deposits to total deposits is now 18.6%. Sometimes savings deposits are considered as one form of time deposits and then the ratio is computed by adding them together. This gives a ratio of 43.6%, which is quite high when compared with other countries. However, it is not totally justifiable to lump together savings and time deposits, for although they share certain characteristics, they are not identical.[1] A savings account could be used like a demand deposit, and thus it is not entirely certain that one could identify it with a time deposit.

The 18.6% ratio of time deposits to total deposits is quite low and one reason for this very low proportion is the interest differential between demand and savings deposits on the one hand, and time deposits on the other. This differential is not high enough to make up for the inconvenience and risk of having one's account on a term basis. This suggests that

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1. See p. 68.

demand deposits are interest elastic, and a fuller discussion of this point will come up later.

Certain banks refuse large funds unless they are deposited on term. Others, even more cautious, refuse large deposits altogether on the grounds that if the depositor asks for immediate repayment the bank cannot turn him down on grounds of notice. But from private interviews I have had with bankers it seems that the latter case is rare.

(d) Foreign Currency Deposits

As stated earlier, any person in Lebanon can open an account in any currency he chooses in any bank in Beirut. Foreign exchange transactions are totally free and thus the currency is chosen purely on the grounds of convenience, confidence and risk. Although it is believed that most deposits in foreign currencies are owned by foreigners, Lebanese people do own a substantial part of them too. The reason is often that they keep proceeds in foreign currency in that same currency for some future payment. This action is a safeguard against exchange risks. For example, an exporter of cotton fabrics to Cyprus or India will be paid in Sterling, part of which he will keep as a Sterling deposit to pay for the importation of machinery from Britain. This practice is also very important in triangular trade.

Deposits in foreign currencies can be either on demand or on term. Separate figures for such deposits exist for the years 1955-1962 only. Now in the official statistics they are added to deposits in Lebanese Pounds. Interest rates received are usally slightly higher than for corresponding deposits in Lebanese Pounds. The reason why this is the case is explained in a later chapter.[1]

Table III shows the growth of deposits in foreign currencies between 1955 and 1962. The increase is remarkable as can easily be seen. Demand deposits still constitute the most important portion, varying around 82% of the total.

Data for the period after 1964 (April), do not mention separately foreign currency deposits, but reliable sources put private - non-bank - deposits in foreign currencies at over £L 600 million;[2] this is quite a large amount as it is equal to 26.3% of deposits in Lebanese Pounds. The importance of these foreign currency deposits and the total freedom to move from the Lebanese currency to foreign ones, will clearly emerge in a later chapter.

1. Chapter IV.

2. Figure privately secured.

TABLE III

Deposits, Advances and Discounted Bills in foreign currencies

In £L thousands.

End of	DEPOSITS			INVESTMENTS	
	Fixed	Sight	Total	Advances	Bills Discounted
1955	12,661	58,516	71,177	41,102	5,105
1956	16,266	65,756	82,022	57,318	8,591
1957	18,232	97,085	115,317	73,512	31,454
1958	17,000	120,000	137,000	72,000	5,000
1959	33,000	132,000	165,000	91,000	6,000
1960	53,700	314,900	368,600	147,700	11,600
1961	72,000	380,000	452,000	146,400	15,100
1962	78,500	380,100	458,600	124,900	14,237

Source: BSL, *Rapports*.

(e) Banks and correspondents

Table II gives the available figures for interbank deposits in the column 'Banks and Correspondents'. They are put alongside other deposit figures for comparison: they are equal to over half the total of column 2, 3 and 4. Data relating to interbank deposits before April 1964 do not exist, but the amounts revealed in the new statistics lead us to think that they must have been substantial.

The magnitude of these deposits is important as it gives an idea of the activity of the money market in Beirut. The chief function of this money market is to enable the banks to cover their cash requirements or to employ their excess liquid resources[1] among themselves. Thus, Bank A in need of Lebanese Pounds contacts Bank B which, if it has the required amount, will deposit it with Bank A and receive interest on it. The deposit can be on sight, at notice or with a fixed maturity. The operation may take place in any currency, and the liquid resources of the banks do not have to be limited to the ones in Lebanon. Thus foreign banks may and have brought in funds from their head offices abroad which they have injected into the Lebanese money market. Alternatively, Lebanese banks can ask for funds directly from non-resident banks. For example, if resident bank A is in need of £L 850,000 and it has no

1. There are no Treasury Bills and no short-dated Government Securities in Lebanon.

adequate paper for rediscounting, it may ask non-resident bank B for, say, £100,000 which, if B is willing, will be deposited with A. This latter will deposit the £100,000 with the Central Bank - previously with the BSL - and get a loan of £L 850,000 which is roughly the equivalent. When payment falls due, A will give the £L 850,000 back to the Central Bank, and withdraw its £100,000 which will be returned to B.

According to very reliable figures,[1] £L 469.6 million were due in April to non-resident banks, and £L 552.3 million to resident banks. The Bank of Lebanon was owed £L 64.3 million. We notice that the sum of the three items comes to £L 1,086.2 million which is above the corresponding figure given in Table II. The reason is that in the latter figure amounts due to head offices, subsidiaries and agencies outside Lebanon are not included: they come under another section called 'miscellaneous creditors'. The difference of £L 167 million between the two totals, must be then what banks, with head offices or subsidiaries or agencies abroad, brought into the country.

1. Privately secured.

The importance of the money market in Beirut should by now be clear: it enables banks to meet sudden shortages of cash or liquidity without having to ask for the help of the Central Bank (or previously of the Banque de Syrie et du Liban). Its activities are tantamount to those of a lender of last resort. This money market is somewhat similar to the American correspondents relationships, or to the French 'Marché Hors Banque' described in the first chapter.[1] But the Lebanese Marché Hors Banque or MHB differs in ome important way from the American and French arrangements. In the United States, banks could only make full use of existing reserves. They could not expand them when the need arose. Put simply, they just made the best of what was available. Although their activities looked somewhat like those of a lender of last resort, they could not meet a general crisis in the banking sector. The inadequacy of this system was clearly demonstrated by the 1907 crisis. In that year, faced with an unusual demand on their reserves, and unable to acquire extra ones, city banks froze on to what they had,

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1. See Chapter I pp. 25-28.

hoping to remain solvent. Country banks could not get the help they had expected from their city colleagues, and they had no alternative source of funds. It was then that the real need for a lender of last resort was felt.[1]

The French MHB provided also a better use of the reserves held by the banking sector, and it was quite useful in normal times. But just like the Correspondent Relationship in the United States, it could not by itself help the banks in times of crises. The difference from the United States, however, was that the Banque de France stood ready to rediscount paper when the need arose. But when the banks went to the Banque de France, they were no longer operating in the Marché Hors Banque by definition.

The difference between the Lebanese MHB and the American and French arrangements is that foreign banks take a very active part in it. Theoretically, their presence makes possible unlimited supplies of money for all practical purposes as they can always ask for funds from their head offices to deposit or to relend to Lebanese banks, which are in difficulty.

1. The outcome was the Federal Reserve Act of 1913. An outline of the steps leading to it was presented in the first chapter.

The figures given above are evidence of that sort of thing happening. The presence of the foreign banks makes the Lebanese MHB a proper lender of last resort, and one that can cope with emergencies because the reserves of the banking sector are not limited by the domestic supply but can be expanded with more funds from abroad. This is the great importance of foreign banking in Lebanon. A foreign banker in Beirut told me that 50% of his credits go to Lebanese banks.

It is very important to stress here the magnitute of what one could call 'foreign intervention' in the Beirut money market. The fact that so much money can be made available from abroad - £L 469.6 million in April and £L 614.0 million in September 1964, whether from non-resident banks or from overseas head offices subsidiaries or agencies, is very important and has implications for monetary policy.

The rates of interest paid on interbank deposits vary, depending on the currency used, the origin of the funds - i.e. where they came from -, the nature of the deposit, the standing of the bank, the supply and demand positions, and finally the amount of rediscountable paper held by the borrowing bank. The first factor needs to be explained: if the funds deposited are surplus liquid resources in Lebanese Pounds, the rate paid is lower than if the funds were in foreign currency or had to be brought from abroad. The reason is that to discourage the foreign investment by a bank of foreign currency acquired in Lebanon, or to encourage the import of funds from abroad, the rate offered in Lebanon has to be higher than the one that those funds would yield abroad. Funds in Lebanese Pounds can only be invested in Lebanon; if they are converted into foreign currency, they can be invested abroad. But such investment has to yield a rate of return that takes into account the exchange risks incurred in converting Lebanese currency into foreign currencies. Banks may not always want to take such exchange risks and thus they are willing to deposit their surplus Lebanese currency with other banks in need of them and at a rate that satisfies the other factors involved.

The amount of rediscountable paper held is important, for if bank A needs Lebanese Pounds and holds such paper, it can rediscount it at 3% at the BSL.[1] Therefore bank B with surplus Lebanese Pounds at its disposal must accept less than 3% on the funds it can deposit with A. Otherwise the latter would prefer rediscounting.

1. This means that the BSL rediscount rate sets an upper limit on the rate that banks would charge each other on rediscountable paper. The rate on other paper could be higher.

(f) Miscellaneous Creditors

This is an item that appears in the new set of figures. Apart from the credits granted by head offices subsidiaries branches or agencies of banks outside Lebanon, are included here the accounts of directors and associates. Other such creditors are debtors accidentally creditors of the bank, i.e. who have been authorised an overdraft and suddenly deposit more than they have withdrawn. Also under this heading are included guarantees received by the bank in cash, sums blocked by virtue of a regular contract as guarantee for current risks, or because of a legal case, and finally fees and taxes collected by the bank from a third party on behalf of the fiscal authorities.

Column 6 of Table II shows the amounts due to miscellaneous creditors from April to September. As is clearly seen they are substantial. With the data available we cannot explain the sudden drop of nearly £L 100 million in August which was more than compensated for in September.

2. Assets

Although very detailed data are available to the new Central Bank,[1] they are not published in a very enlightening way, and as

1. See Statistiques Bancaires Instruction No 1/62, published by the Ministry of Finance.

mentioned earlier, private sources had to be used.

A. Cash

Cash ratios for the period prior to April 1964 cannot be calculated for lack of sufficient data. The exercise is however possible for the period after April on the basis of privately secured information.[1]

For April 1964 cash in tills and with the Bank of Lebanon amounted to £L 105.4 million while holdings of foreign currency and coins were £L 3.7 million. This makes total cash holdings equal £L 109.1 million. These figures and the corresponding ones for September can be seen in Table IV.

The cash ratio is seen to be very low compared to other countries. Thus it was 4.5% in April and only 2.5% in September. This compares with an average of 8% for the United Kingdom. There are two main reasons for the very low ratio in relation to other countries. One is the high liquidity ratio maintained and the other is the fact that banks do not really need to keep more. Both of these will be discussed later.

1. Cash and liquidity ratios have never before been compiled for the Lebanese banking system.

B, Liquid assets

Money at call is added to cash holdings in the official figures. These can be seen in Table IV. From £L 1,070.3 million in April they rose to £L 1,148.9 million in July and they fell back to £L 1,075.7 million in October, probably due to a fall in the cash holdings which in turn was reflection of the fall in demand deposits. Money at call represents sight assets at other banks which, with uncleared cheques, amounted to £L 959.8 million in April and £L 1,036.0 million in September.[1]

Table IV gives also figures for the commercial bill portfolio of the banks. There was one slight decrease in May but otherwise increases in absolute terms were recorded. It is interesting to note how commercial bills have been faring. Table V shows this for the period before April 1964. The proportion in the total money lent fell steadily from 30.7% to 22.2%. Although the data in Table V are not complete in that they do not encompass all banks, the ratio and the trend seem correct because if we consider the data for April 1964 the ratio stood at 16.9%.

The liquidity ratio can now be calculated. For April 1964 it was 42.1% and for September 43.2%.[2] In the numerator we included

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1. Figures arrived at thanks to privately secured data.

2. The ratio may be overstated because only gross figures are available for the interbank business, and a large part of the bills portfolio held by banks is in the form of accommodation paper not rediscountable at the BL in ordinary circumstances but are negotiable at other banks. To the extent that such bills are not as liquid as rediscountable bills the liquidity ratio is inflated.

TABLE IV

EXTRACTS FROM THE BANKS' ASSETS IN L.L. MILLION

Month (1964)	Cash and at call (1)		Portfolio Bills (2)		Advances and debiting a/cs (3)	Portfolio Securities (4)
April	1,070.3		442.4		2,166.7	182.6
of which				of which		
cash	109.1			to non-banks	1,518.8	
at call	959.8			to banks	647.9	
others	1.4					
May	1,086.8		441.8		2,131.0	165.9
June	1,095.0		443.9		2,206.9	158.5
July	1,148.9		448.4		2,247.6	161.3
August	1,045.6		462.6		2,306.0	161.1
Sept.	1,099.6		479.1		2,373.5	164.7
of which				of which		
cash	62.6			to non-banks	1,553.3	
at call	1,036.0			to banks	820.2	
others	1.0					
Oct.	1,075.7		473.2		2,369.1	164.5
Nov.	1,138		473		2,379	163
Dec.	1,244.3		492.0		2,387.7	170.5

Source: Bulletin Statistique Mensuel, and om basis of privately secured information.

TABLE V

ADVANCES AND DISCOUNTED BILLS IN LEBANESE POUNDS

(L.L. Million)

End of	Advances to private sector (1)	Discounted bills (2)	Total (3)	Ratio 2/3 %
1955	272	121	393	30.7
1956	283*	164	447	36.6
1957	361	155	516	30.0
1958	369	159	528	29.0
1959	469	180	649	27.8
1960	659	233	892	26.1
1961	739	265	1,004	26.4
1962	900	257	1,157	22.2

Source: BSL Rapports. The figures exclude advances to the public sector those granted in foreign currencies.

* This figure is misleading as advances fell sharply in November and December following the recall of some loans during the Suez crisis.

cash, balances at the Central Bank, money at call and short term commercial bills. The denominator had all six items of Table II. The ratio is thus higher than is normal in developed monetary systems, but of course the cash element in it is quite small. By comparison with traditional practice[1] this may seem abnormal. But traditional practice should not serve as a guide in this subject: this ratio should be considered in the light of the Lebanese monetary system which will be done later in the chapter.

The liquid assets of the banks are held largely in foreign exchange. In April 1964 the very liquid foreign assets amounted to £L 1,005.8 million and in September they amounted to £L 1,270.5 million.[2] This represents more than double the banks liabilities to non-resident banks. Data on deposits held by non-residents other than banks, are not available, but such deposits are known to be substantial - as can be seen roughly from Table III[3] which gives deposits in foreign currencies, and probably exceed the deposits of foreign banks. As the practice of most banks in

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1. By traditional practice we mean here the practice that prevails in to-day's developed monetary systems which are often taken as models. That was explained in the first chapter, p. 1[illegible].

2. Data privately secured.

3. These figures include a certain amount of deposits owned by residents. That is why they are only a rough guide.

Lebanon has been to maintain foreign assets roughly equal to their total foreign liabilities, these non-bank foreign deposits must be in the region of £L 600 million.

It should be mentioned finally that the Lebanese Government has a very small debt which was entirely held by the BSL and now by the Bank of Lebanon. There are no short dated Treasury Bills banks can take up with their surplus cash and no government bonds for investment.

The discount rate applicable to commercial paper is shown in Table VII.[1] It went down from 6.9% in 1950 to 5.1% in 1955. Then it fluctuated, but until 1964 the trend was upwards. In the last quarter of 1964 it was 7.3%.[2] The factors influencing the discount rate will be considered later in the chapter.

C. Advances

Credit operations of the banks are concentrated mostly on financing trade, both internal and external. Data relating to sectoral advances are not available in detail for the period before

1. See p.95 below.

2. Since then it has fallen to below the 7% mark.

1964. What is available are rough estimates for two years - 1954 and 1957 - compiled for the American Embassy in Beirut. They are only available in percentages and are reproduced in Table VIa. Trade takes the lion's share of advances, although its share seems to have fallen between the two years. Advances to industry are not mentioned separately. These must have been quite small early in the period considered, as industry relied heavily on self financing. But it seems safe to assert that one of the reasons why the ratio of advances to land and buildings increased was not only the fact that this sector boomed considerably; advances to industry were becoming more important and less and less of a short-term mercantile character, so that banks must have gradually included them under the section "advances to buildings".

Table VIbgives estimates as compiled by the Bank of Lebanon. The figures are available for December 1964 only. One can easily see that trade still occupies the first place with £L 987 million being lent to that sector (66% of the total given) industry coming second with £L 236 million, building third with £L 141 million and agriculture fourth with £L 124 million.[1]

1. Source: Bank of Lebanon, Annual Report 1964.

TABLE VI

DISTRIBUTION OF ADVANCES AND DISCOUNTS

(a)

Sector	Percentages. 1954	1957
Trade	60	40
Land & Building	20	35
Public & Government agencies, municipalities	20	25
TOTAL	100	100

Source: U.S. Embassy, Beirut.

(b)

Sector	December 1964 - in £L millions.
Trade	987
Industry	236
Building	141
Agriculture	124

These credits are those extended to residents only (See Statistiques Bancaires Instruction No 1/62 p. 22)

Source: Bank of Lebanon, Annual Report 1964

Advances are granted against the security of some asset or are unsecured. The security accepted varies. Banks accept shares, bills, stocks of goods or even real estate as collateral for their advances. Real estate used to be prominent as a collateral because cautious banks preferred to lend against the security of a tangible asset and because people offered that security; in their minds it was the safest of all collaterals. It may seem strange that banks could lend against the security of such an illiquid asset, and in traditional terms - as defined in the first chapter - it looks risky and unsafe. But the reason banks could do it was simply that in the depositors' minds too, real estate was the safest security, and as long as depositors did not feel nervous about such loans banks could go ahead with them.

Unsecured advances are called 'lines of credit'. A borrower can draw money up to an agreed maximum mentioned in a contract.

Rates of interest charged vary between 5 and 9%.[1] Determinants of the rate include the quality of the borrower, the amount borrowed, the collateral offered, and the maturity of the loan.

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1. It may seem strange that banks can charge such rates when they pay up to $6\frac{1}{2}\%$ on deposits: it would then be relatively easy to borrow from one bank and deposit with another at a profit. This may be happening but not to any significant extent because of the imperfection of the market: banks which offer the highest rates on deposits do not command the same confidence as the others. Besides, if a businessman can borrow at low rates of interest he may well find alternative investment opportunities with higher profit margins.

The terms of loans are usually short. No proper medium - or long-term credit is granted by the commercial banks. The only form of credit approaching medium-term credit is the short-term loan tacitly renewed when it matures. One semi-public institution specialises in medium-term credit but we shall consider it later on.

Table V shows how advances in Lebanese Pounds - including interbank advances - moved between 1955 and 1962. The increase - nearly fivefold - is startling. It is a reflection of the prosperity of the economy and the increasing importance of advances relative to commercial bills. Thus, while the ratio of discounted bills to advances was 44.4% in 1955 it was 28.5% in 1962.

The statistics compiled and communicated by the Bank of Lebanon also include inter-bank advances. They are shown in Table IV. The great increase since 1962 is not real. It is simply that the latter figures are more comprehensive and include all interbank advances - except money at call - and not just a few, as in the previous statistics.

Privately secured information gives us more detailed figures for April and September 1964. In April advances to the non-bank private sector were £L 1,518.8 million, which leaves £L 647.9 million as advances to banks. The corresponding figures for September were £L 1,553.3 million and £L 820.2 million. This shows again the extent of co-operation among banks.

We have not got sufficient data yet to adjust for seasonal variations. However, we tried to do it for the figures before April, 1964, and there was no sign of seasonal factors at work.

Banks can grant advances in foreign currencies. These are quite important and are normally equal to about 15% of advances in Lebanese Pounds. From £L 41 million in 1955 they rose to £L 125 million in 1962.[1] The banks used part of their foreign currency deposits to grant such advances repayable in the same currency. We have no separate data for advances in foreign currencies granted after April 1964. They are added to advances in Lebanese Pounds.

The ratio of advances to deposits can now be calculated. It is not worth doing it for the period before April 1964 because some - and not all - interbank advances were included in the estimates, and deposit figures included some interbank deposits. For April and September 1964 the ratios of advances to the non-banking private sector to non-bank deposits - including some of the miscellaneous creditors - are 60.7% and 60.5% respectively. Here banks seem to stick to the general rule of trying to maintain a 60% advance to deposits ratio.

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1. See Table III p. 73.

D. Portfolio - Securities

These are the least liquid assets held by banks. No data are available before April 1964 so we concentrate on those figuring in Table IV. They comprise securities issued by the Lebanese and foreign public sectors, Lebanese and foreign investment and participation securities, and cashable coupons and securities.

Resident banks do not hold Lebanese government securities but may hold foreign ones. The domestic investment portfolio amounted to £L 75.0 million in April and £L 56.4 million in September. The foreign investment portfolio was equally important with respectively £L 75.1 million and £L 56.4 million. The fall in these two components, which constitute the main part of the total, was responsible for the decrease in the latter between April and September. Participation in industrial ventures is thus quite small.

The reason for the fall may be attributed to the banking difficulties in the spring of 1964 following the failures of two banks,[1] and a fear of a credit squeeze by the new Central Bank. Rather than call back their advances, banks preferred to sell

1. This caused certain withdrawals from other local banks.

some of their investment portfolio, which they could replenish once the difficulties were over. This move is clearly seen in the fact that in September the figure was increasing again, for by that time things were back to normal.

The ratio of such investment to total deposit liabilities can again be calculated. In April it was 5.1% and in September 4.2%. If we exclude interbank deposits the ratio becomes 7.3% and 6.4% respectively. These can be seen to be quite low. The reason for this low ratio is that part of the illiquid investments of banks goes into building. Thus the figures for April and September are £L 123.4 million and £L 141.2 million respectively. The ratios of these to total deposit liabilities are 3.1% and 3.7%. Thus if we include the investment in building we get a more accurate investment ratio of the banks. It varies then around 8%.

E. <u>The Discount rate</u>[1]

Before leaving our discussion of the banks' assets we must consider briefly what determined the discount rate during the period 1950-1964. The rate was determined solely by market conditions and no intervention to influence its movements took

1. i.e. the rate applying to customers.

place, unlike most countries where central banking action can influence its fluctuations. The trend was downward until 1955 and then upwards to reach 7.3% in 1964. The factors determining the very small and gradual changes - as can be seen in Table VII - were economic and political. The economic factors were deposits, currency circulation, claims on the private sector and state finance. Political factors were important in so far as they affected the economic ones and especially deposits.[1]

III OTHER FEATURES OF THE BANKING SECTOR

Before moving on to an appraisal of the liquidity position of the banking sector it may be interesting to consider briefly interbank co-operation. One aspect of it is, of course, the Marché Hors Banque, which allowed a full use of the reserves of the banking sector. Its importance as a lender of last resort and as a 'hidden money market' has already been discussed and measured. The function served by the Marché Hors Bank has been completely overlooked by writers on Lebanese banking. Another aspect is the Centrale des Risques designed to help the banks assess more accurately the credit-worthiness of borrowers. The Centrale is described in more detail in Chapter V.

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1. See Appendix for more details on the movements of the discount rate.

TABLE VII

AVERAGE MARKET DISCOUNT RATE 1950-1964.

Year	Quarters I	II	III	IV
1950	6.905	6.843	6.703	6.746
1951	6.677	6.623	6.660	6.556
1952	6.486	6.520	6.416	6.440
1953	6.213	6.136	6.110	6.153
1954	5.896	5.566	5.406	5.050
1955	5.186	5.163	5.206	5.233
1956	5.246	5.253	5.330	5.220
1957	5.356	5.236	5.273	5.326
1958	5.493	5.503	5.620	5.700
1959	5.886	5.900	6.080	6.060
1960	6.020	5.970	5.733	5.666
1961	5.66	5.60	5.65	5.70
1962	5.70	5.70	5.76	5.91
1963	5.96	5.99	6.26	6.69
1964	6.94	7.03		7.3

Source: I.M.F. International Financial Statistics

Finally there is the Lebanese Banks' Association. This body has been growing in influence in recent years. It may be compared with the Committee of the London Clearing Bankers or with the Belgian Banking Association in that it represents the interests of the banks in negotiations with the Government, and more recently with the Central Bank. But it differs from them in that it does not fix a scale of deposit rates. This is important to remember.

As noted in Chapter I the Association was consulted closely when the Code de la Monnaie et du Credit was being drafted. It exerted great influence in the setting up of the new Central Bank and in determining the power to be given it. However, it has no powers over banks, nor does it fulfil any educational or examining functions.

IV APPRAISAL OF THE BANKING SECTOR

A consideration of the liquidity position of the banking sector is useful for three reasons. One is that it will help in a later discussion on whether banks can contribute to the financing of the economic development of Lebanon. Another reason is that it may throw some light on whether a Central Bank was needed to control the liquidity position of the banking sector, for as already described the banking profession was totally unregulated in Lebanon and this has been the cause of widespread criticism. Finally it will help later to assess the scope for monetary policy.

The cash ratio kept by the banking sector as a whole was 4.5% in April and 2.5% in September 1964. On the one hand this figure seems low if compared to other countries, and on the other it seems to fluctuate sharply. Could this be held against the banking sector or is there nothing dangerous about it? In other words why can the banks keep such low cash ratios? To answer this question an examination of the nature of deposits and of the liquidity ratio is necessary.

1. Nature of deposits

Time deposits constitute only 18.6% of total deposits. Considered as it is, this is a low proportion and would traditionally[1] imply that banks should keep higher cash ratios than they do at present. But two factors militate against this: the proportion of savings deposits in the total deposits and the use made of demand deposits.

A. Savings deposits

Savings deposits, constituted in September 1964 30.8% of total private and non-bank deposits. From the point of view of the banks' need for ready cash they are closer to time deposits than to demand deposits. The time deposits proportion of 18.6% is thus misleading when taken by itself. The nature of the savings deposits reduces the need for a higher cash ratio.

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1. See footnote 1 page 84 for meaning of traditional.

B. Demand deposits

These deposits constitute the largest proportion of deposits. Generally speaking, depositors keep on demand what they think they will need for transactions purposes plus a varying amount to hedge against unforseen expenditure. Their surplus liquid resources are either invested in stocks, shares or real estate, or deposited on term to receive interest. The extent to which depositors behave this way can be judged by consideration of the annual turnover of demand deposits. When deciding whether the turnover is high or low due regard should be given to the average income payments intervals in the country. If the payments interval is long one would not expect a large turnover figure.

To compute the turnover of demand deposits we can divide the total debits figures of the banks over periods of one year, by the corresponding amounts of demand deposits. But for Lebanon no data relating to debits are available, and we shall use an alternative method. This consists in using clearing figures instead of bank debits. It is less satisfactory as it does not include direct encashments over the banks' counters, and clearing within one bank. To make up for this we propose to increase the clearing figures by 50%. This seems adequate as in the

Lebanon branch banking is not predominant yet - when there are many banks there is less likelihood of clearing within one bank.

Table VIII shows the turnover of demand deposits in the years 1950-1963. The adjusted figure is computed by increasing total clearings by 50%. The turnover, or crude velocity, is shown in column 4, and a turnover of 3 means that the deposits are used once every four months. There are very few weekly wage earners in Lebanon and the income payments interval is either two weeks or one month. When this is compared to the turnover figure, it is immediately noticed how low it is.[1]

There is however one reservation that has to be made. The turnover figures given in Table VIII are too low because the deposits data are swelled by some interbank deposits and by some savings deposits. A more accurate figure can be found for the year ending in April 1964, and here we include current accounts and checking accounts in the deposits figure. The turnover then is 4.5, which means that total demand deposits are used only once about every two and a half months. This is still a very low figure when compared to the income payments intervals.

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1. The great increase in 1951 was not due to an increase in commercial transactions in Lebanon but to speculative financial operations caused by the Korean War, which were reflected in the exchange market where the dollar rate rose considerably (LL.3.87) as a result of large imports and stock piling.

TABLE VIII

TURNOVER OF DEMAND DEPOSITS

IN L.L. MILLION

Year	Total Clearings	Adjusted figure	Dem. Deposits	Turnover
1950	364	546	210	2.6
1951	553	1,229	253	4.8
1952	722	1,083	301	3.5
1953	574	862	324	2.6
1954	639	959	362	2.6
1955	926	1,392	444	3.1
1956	1,222	1,833	440	4.1
1957	1,454	2,181	551	3.9
1958	1,370	2,055	559	3.6
1959	1,941	2,911	778	3.7
1960	2,228	3,341	955	3.4
1961	2,413	3,620	1,082	3.3
1962	2,593	3,889	1,268	3.0
1963	3,617	5,425	1,402	3.8

Source: For clearings and deposits Bulletin Statistique Trimestriel. The adjusted figure is total clearings increased by 50%. The turnover is obtained by dividing the adjusted figure by the demand deposits.

This suggest that demand deposits are not used in Lebanon the way they are used in more developed monetary systems, and therefore a traditional approach to them is misleading: a large part of the demand deposits are carried forward all the time without being used. This is very important as will emerge later and it is worth considering why demand deposits have this characteristic.

(a) Interest rate policy

The structure of interest rates is a very important factor. Demand deposits receive high rates of interest ranging between 3 and 5%. So one of the reasons why people deposit on sight more than they actually need for transactions purposes is the fact that the difference between the rates offered on demand and on term is not large enough to make up for the inconvenience and sacrifice of having the deposit on term. The difference within one bank rarely exceeds 1%, while demand deposits in one bank receive a higher rate than time deposits in another. This is confirmed by the fact that when the rate on a demand deposit is fixed, the banker has regard to the frequency of use of the deposit: the higher the balances kept, the higher the rate.

The conclusion that demand deposits in Lebanon are interest elastic can here be drawn, and it can be assumed that if less interest - or no interest - was paid on them, savings and time deposits - which are less liquid - would increase. Therefore, a large part of the demand deposits are just a form of time deposits, which in ordinary circumstances are not used for current transactions, and which, in more developed countries might have been invested in stocks and shares, and which finally swell the denominator of the ratio giving the turnover, producing a very low figure for the latter.

(b) Banking Secrecy

Another factor accounting for the very low turnover of demand deposits is the Banking Secrecy Law of 1956 which attracts foreign deposits to the country. `Conditions are ideal for:

(i) anonymity is secured

(ii) interest is paid on demand deposits

(iii) funds can be deposited in any currency.

In the Middle East these conditions are important for depositors, and their funds, while swelling the demand deposits total, are not currently used. In Switzerland where no interest is paid on demand deposits, a large part of these funds would have been deposited on term, or invested in securities.[1]

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1. Even then, owing to the vast amounts of foreign capital Switzerland receives, the crude velocity of sight deposits never reached the figure of 1 in the period 1950-63: it fluctuated between 0.5 (1958) and 0.8 (1963). Figures based on statistics for the largest 62 banks, published in Bulletin Mensuel by the Banque Nationale Suisse.

(c) Social Causes

Generally speaking, the development of welfare institutions tends to increase the velocity or turnover of demand deposits. The reason is that less money is then needed to be kept on sight as a precautionary measure against illness, unemployment, and the like. Social and medical insurance which usually appear at some stage of development, tend to affect the sight balances carried forward from one income payment period to another. In Lebanon welfare institutions are still in their embryonic stage, and their effect is not felt yet. Therefore more balances are kept with a precautionary motive than in those countries which are taken as models of banking behaviour.

(d) Lack of alternative safe liquid assets

The third factor mentioned raises a question: if people wish to keep certain liquid balances for unforseeable events why do they not acquire liquid assets or shares which could be sold easily, and with no great capital risk? The reason lies simply in the fact that such assets do not exist in Lebanon. There are no Government securities yielding a relatively fixed rate of interest. The Stock Exchange or the Bourse as it is called, is badly organised and very narrow: this affects adversely the liquidity of shares. Moreover the capital risk is great as the shares are subject to dangerous speculation.[1] Liquid investment lacking, people, Lebanese and foreigners alike, resort to the liquid, safe and interest-yielding demand deposit.

(e) Business deposits

In the statistics communicated by the Bank of Lebanon. business deposits are mentioned separately. Their proportion in total demand deposits varies around 50%, but their absolute magnitude will not help us in our discussion until we have separate figures for their debits. Businesses always have to keep certain cash or very liquid balances, the magnitude of which is determined by the nature of their activities, their expectations of future cash requirements and the ease with which they can acquire funds for investment relatively cheaply and quickly. One can assume that with experience firms know roughly how much they need with respect to the first two factors, and thus one would assume that very little of such cash is carried forward from one period to

1. See Chapter III for details.

another. The third factor - namely the ease with which firms can acquire funds releatively quickly and cheaply - is important and deserves consideration. Credit is usually available from banks, but on short-term only. Medium-term credit is available from two sources, but both are unsatisfactory. The first one is the commercial banks, and it takes the form of three monthly bills renewable over a certain number of years. It is unsatisfactory because it is expensive. Fiscal legislation in Lebanon imposes a stamp duty of 2% (8% per year) on the creation or extension of any bill. Thus for a five-year term credit stamp duty alone would add 40% to the cost of hiring the money.

The second source of medium-term credit is the Banque du Crédit Agricole Industriel et Foncier, or in short the B.C.A.I.F.[1] But this institution:

(i) has very limited funds at its disposal,[2]

(ii) must abide by very strict rules which discriminate against medium and small-size enterprises, and

(iii) cannot help in the provision of working capital which firms might need.

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1. Founded in 1954 with a capital of £L 5 million 2/5ths of which is subscribed by the State. Its resources come from borrowings guaranteed by the State. The law stipulates that 2/5ths of its advances should go to agriculture, 2/5ths to industry and 1/5th to hotels.

2. Advances increased from £L 4.850 million in 1955 to £L 56.900 million in 1959, but are still very small when compared to total advances by the commercial banks.

In contrast to the money market, the capital market is very undeveloped, and as will be explained later,[1] is inefficient in the provision of adequate funds and does not provide adequate investment opportunities for investors. Therefore this leaves self-finance, and businesses keep reserves for that purpose. In countries with more efficient markets these reserves would have been invested in very liquid assets until they were needed. But such assets do not exist in Lebanon as explained earlier, and the only alternative is deposits.[2] Some reserves are kept as time deposits and others as demand deposits. But the latter are preferred for reasons already explained, and the funds thus deposited account partly for the very low turnover of the demand deposits.

For all these reasons, demand deposits in Lebanon are not used in the traditional way, i.e. for transactions purposes only: it is highly probable that a large part of them would, but for these factors, have featured as time deposits, or would have been invested in stocks and shares, for the purposes of **liquidity.** Thus demand deposits are not as high as the figures seem to show them, and their apparent magnitude is no argument for a higher cash ratio.

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1. See Chapter III pp. 151-153

2. This applies also to reserves kept for pensions, gratuities, etc.

Having considered the nature of the non-bank private deposits in Lebanon, we notice that although technically the largest part of them is on sight - withdrawable by cheque or over the counter - savings deposits - practically the largest part can be considered as time deposits. When looked at from this angle, the cash ratio does not appear very low.

2. Liquidity Ratio

Although the cash ratio is very low - or seems very low, the liquidity ratio is quite high, if compared to that prevailing in developed money markets. It is not only high by international comparison, but also because of the nature of deposits in Lebanon which has just been considered. Thus, banks can claim a high ratio of readily and easily realisable assets, which reduce further the necessity of maintaining a higher cash ratio.

Now it may be possible to answer one of the questions asked at the beginning of this section: was there any need for a central bank to control the liquidity position of the commercial banks? If we consider the commercial banking sector as a whole, it seems to have been highly and safely liquid so far, and thus control seems unnecessary. But there is a reservation in that we have been dealing with global figures only. The ratios computed on these figures do not actually reflect the positions of each individual bank, as they were free to fix their own ratios. The ones calculated are really averages which implies that certain banks kept higher whereas others kept lower ratios. So although we have given an answer for the banking sector as a whole, nothing has been said about banks individually.

But a rough answer to the last point can be found in the consideration of the performance of the banking sector. On the whole confidence in its stability - forgetting political stability - never faltered, and there has been only one major bank failure - in March 1964. The directors of that bank were too reckless and took too many risks.

What prevented other bankers from taking similar risks are two powerful checks on their activities. First is the Clearing House where each bank sends two representatives. If any bank postpones a payment or shows signs of difficulty, it is immediately known and other banks can, at once, withdraw their deposits from that bank.[1] As the banking sector in itself is a very important lender of last resort, a bank in this position will have difficulty in finding the required funds, especially if it holds no rediscountable paper. So every day each bank has to convince the others that it has enough liquidity. The second check is public opinion. Lebanon is a small country with a small financial community where rumours propagate themselves rapidly. Any doubt about

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1. That is exactly how the Banque Foncière failed in March 1964. This is the same sort of check as was being exercised on American banks in the XIX Century. See Chapter I pp.31

the liquidity position of a bank can easily be translated into a run on the deposits it holds.

Since April 1964 the Bank of Lebanon has received monthly data on the positions of the banks, and although there are still no statutory ratios to abide by, this is now a further check on the banks.

So on the whole the banking sector in Lebanon was generally very liquid, and the control of its activities and especially its liquidity position by a Central Bank should not have been the determining motive for establishing one, as has sometimes been suggested.[1]

1. See Toak, J. W. J. op. cit. p. 149.
Yaffi, T. "A Case for Banking Reform in Lebanon" in Middle East Economic Papers, pp. 109-10.
Mahmassani, Y. A. A Central Bank for Lebanon, Feghali Press, Beirut, 1958, p. 93.

Appendix to Chapter II

Movements of the market discount rate

Many writers on banking in Lebanon[1] have mixed up the market discount rate with the BSL rediscount rate, and have said that the rate moved cyclically and not anticyclically.[2] It was stated that when profit is a primary motive, this is bound to happen: in a recession the rate goes up because profits still have to be earned for shareholders, and in a boom the rate goes down to take advantage of the increased demand for funds. Thus fluctuations are exaggerated. It was claimed that this was happening in Lebanon, and it was then said that a central bank was necessary to influence the discount rate in a way more conducive to the public interest.

Beside the fact that no evidence was presented to demonstrate that Lebanese banks behaved in this fashion it is contrary to what we would expect from the relation between supply and demand in the cycle. If interest is paid for the hire of finance, movements of supply and

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1. Yaffi, T. op. cit., p. 105, Mahmassani Y.A., op. cit. p. 64, Toak J. W. J., op. cit. pp. 121-123.

2. Having said that the same writers then attacked the BSL for working against the public interest. The rediscount rate of the BSL was fixed at 3% in 1953 and remained unchanged all the time.

demand would tend to make it move anti-cyclically. When the demand for funds increases relatively to their supply - in a boom - banks become less liquid and the market is then more a sellers' than a buyers' market: in this case interest rates will tend to rise.

There are, unfortunately, no index of industrial production or other indices of output to which movements of the discount rate can be compared and judged. What we shall do is to compare those movements to the fluctuations of other economic factors which give an idea of the economic activity of the country.

The best indicator of economic activity - and the most reliable - that we have found is the claims on the private sector. These include advances and discounted bills. We plotted the values on a log graph alongside total currency supply,[1] state revenue and expenditure and national income. The discount rate values are not on a log scale, as the changes are very small. The values can be read in Table VII,[2] IX, X, XI and XII. Where available, quarterly figures were used.

A word of warning should be voiced here regarding the reliability of the statistics. Although all care possible was taken in their selection and verification, we should concern ourselves more with trends and movements than with actual magnitudes.

1. i.e. currency circulation plus currency held in banks.

2. On p. 95 above.

TABLE IX

CLAIMS ON THE PRIVATE SECTOR (L.L. Million)

Year	I	II	III	IV
1950		263		
1951		303		
1952		336		
1953		360		
1954		370		
1955	334	353	337	393
1956	424	428	451	447
1957	434	478	512	516
1958	542	565	549	528
1959	529	556	596	650
1960	762	847	918	1,002
1961	1,091	1,097	1,111	1,108
1962	1,133	1,136	1,128	1,137
1963	1,451	1,506	1,632	1,733
1964	n.a.	1,856	1,910	1,945

Sources: 1950-56: BSL <u>Rapports</u>
1957-64: IMF <u>International Financial Statistics</u>
1950-54 figures are averages for the year
Advances in foreign currencies are included from 1960 onwards.

T A B L E X

TOTAL CURRENCY SUPPLY IN LEBANON*

IN L.L. MILLION

Year	Quarters			
	I	II	III	IV
1950	---------------- 196 ----------------			
1951	---------------- 208 ----------------			
1952	---------------- 200 ----------------			
1953	---------------- 199 ----------------			
1954	---------------- 223 ----------------			
1955	243	252	264	266
1956	270	282	300	333
1957	328	342	347	356
1968	356	407	424	399
1959	394	394	397	400
1960	400	416	427	431
1961	431	431	431	437
1962	437	442	455	470
1963	470	485	493	505
1964	522			

Source: BSL Rapports. Figures for 1950-54 are averages for the year
* i.e. including currency held by banks.

T A B L E XI

EFFECTIVE STATE REVENUE AND EXPENDITURE (L.L. Million)

Year	Revenue	Expenditure	Surplus ( ) or Deficit (-)
1950			
1951	105.3	90.0	15.3
1952	124.9	88.5	36.4
1953	141.2	96.3	44.9
1954	157.4	111.1	46.3
1955	178.8	132.3	46.5
1956	191.9	161.3	30.6
1957	209.9	192.4	17.5
1958	225.4	181.6	43.8
1959	250.4	198.5	51.9
1960	316.5	243.0	83.5
1961	313.4	269.2	44.2
1962	360.1	415.2	-55.1
1963	412.7	430.3	-17.1

Source: Clôture des comptes du service de la comptabilité du Ministère des Finances. Secured from the Ministry of Finance.

TABLE XII

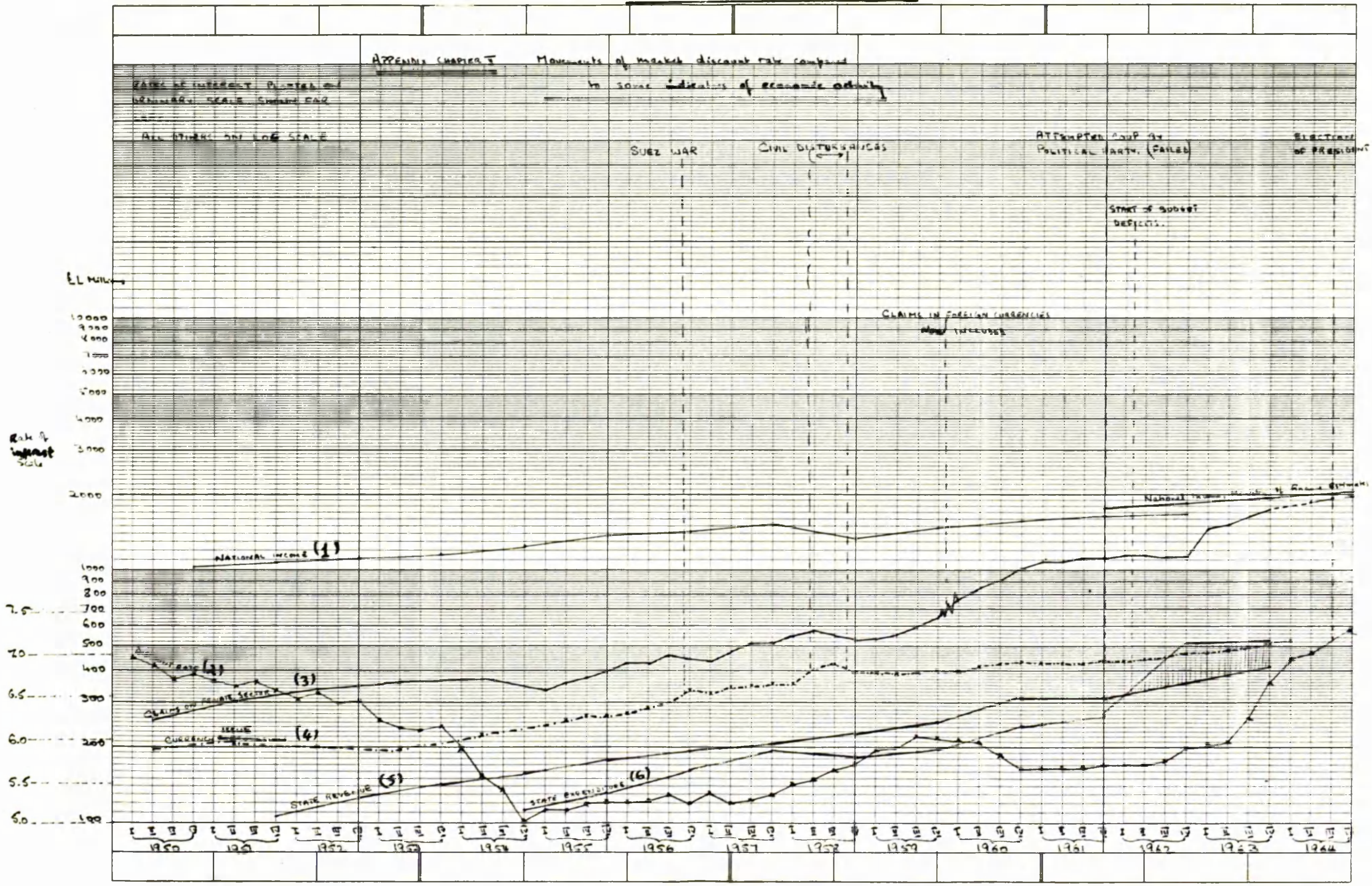
NATIONAL INCOME OF LEBANON (L.L. Million)

Year	Estimate	
1950	1,042	
1951	1,086	
1952	1,115	
1953	1,168	
1954	1,256	
1955	1,374	
1956	1,417	
1957	1,503	
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

Figures constant at 1954 prices

Sources: 1950-58 A. Y. Badre
1959-62 American Embassy, Beirut
1961-64 (Right column), Ministry of Finance, (No mention whether at constant or current prices. Probably current prices).

Movements of market discount rates compared to some indicators of econonomic activity 1950- 1964



1. National Income
2. Discount Rate
3. Claims on Private Sector
4. Currency Issue
5. State Revenue
6. State Expenditure.

Source: Tables VII, IX, X, XI, XII

The most significant years to consider are those after 1958 because the data are then more complete and, as we shall see, many factors were at work influencing the discount rate. 1958 is an interesting year because at first glance it seems that the discount rate rose when claims on the private sector fell. It rose from 5.326% in the fourth quarter of 1957 to 5.700% a year later. In the same period claims on the private sector rose by 8.5% only, while the average per annum increase between 1950 and 1963 was 41%. Furthermore in that same period national income fell by 11.8%.

How can we account then for this seemingly abnormal movement of the discount rate? The reason it moved the way it did was because the crisis was more of a political nature than of an economic one. In that year political disturbances brought the country to a stand-still for six months. Nothing could be done to the economy until the political crisis was solved. In the banking sector "the crisis took the from of a general withdrawal of deposits while repayments became increasingly difficult".[1] This is clearly seen by the great increase in the total demand for currency and by the fall in the deposit figures. From

1. BSL, Rapport 1959.

£L 356 million in the first quarter of 1958 the currency issue rose to £L 424 million in the third quarter thus increasing at a yearly rate of 38%, when the average annual rate for the whole period (1950-64) was 11.7%. Currency circulation rose from L.L. 341 million to L.L. 408 million in the same period,[1] reflecting the great demand by the public. The increased currency circulation was entirely due to a lack of confidence in the ability of the banking sector to withstand the severe strain caused by the political crisis, to doubts about the solvency of debtors, and to a greater meed to have cash readily available. This caused people to withdraw their deposits and to discount the bills they held. Sight deposits fell from £L 605 million in the first quarter of 1958 to £L 468 million in August. Demand for funds might have slackened but their supply became very short, and it was normal that the market discount rate should rise.

It is doubtful whether had the market discount rate been managed, it would have been made to move very differently from the way in which it did move. There was no recession that could have been cured by economic measures. Confidence had to be restored and people had to be

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1. Source: I.M.F. International Financial Statistics.

convinced and encouraged to keep their deposits in the banks, and not to discount their bills. A lowering of the rate might have accelerated the withdrawal of deposits and the discounting of the bills.

In 1959 claims on the private sector started rising at the very rapid rate of 51% per annum, while the total currency issue fell steadily[1] until the end of the second quarter of 1959, at which level it was kept practically constant until the first quarter of 1960. Moreover, since 1957 the State budget surplus had been increasing. Finally sight deposits, which were the main part of total deposits, did not reach their pre-crisis level until April 1959. These factors put a heavy strain on the liquid resources of the banks which did not have much excess liquidity after 1958 anyway. In those circumstances the discount rate rose - as would be expected when left to market forces - from 5.7% in the fourth quarter of 1958 to 6.80% in the third quarter of 1960.

The rise in the discount rate, though modest, was not unwelcome, as there were obvious signs of overheating in the economy after the long stagnation of 1958: for example, credit to the private sector

1. To relieve the banks of the considerable strain they experienced, the BSL must have rediscounted 'en pension' or made loans to the banks. Such advances were repaid when deposits came back, thus making possible a withdrawal of the emergency currency issue which had to be done.

was rising one and a quarter times faster than the average for the period 1950-64.

In 1960 currency supply started growing again at the rate of 7.75% a year. At the same time currency held by banks increased from L.L. 15 million in the fourth quarter of 1959 to L.L. 32 million in the fourth quarter of 1960.[1] This eased the pressure on the liquid resources of the banks, and the discount rate fell back to 5.60% in the second quarter of 1961.

But on 31st December 1961 an attempted coup d'état caused considerable uneasiness in the country. The revolt was crushed inside a few hours with about five deaths, and was therefore too short-lived to have much immediate effect on the economy. But as a report on the Lebanon said ".... damage to the Lebanon's main commercial asset - confidence in the country's stability - is inescapable".[2] This was bound to have its first repercussions on the banking sector, and private (non-bank) deposits are known to have left the country in substantial amounts.

So although in that period there was a fall in the rate of increase of credit to the private sector, the discount rate remained stationary as banks felt some strain on their liquid resources. There was no real need

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1. Source: I.M.F. International Financial Statistics

2. Economist Intelligence Unit, Three Monthly Economic Review, No. 24 February 1962, p. 6.

for a reduction in the discount rate as there was no real recession. In fact national income was growing at 5.6% a year which is only 0.6% slower than the average 6.2% for the whole period if 1958 is excluded.

An increased currency issue followed, easing the strain on the liquid resources of the banks. But money remained very tight, which was strongly felt at the end of 1962 when credit to the private sector started growing at the annual rate of 52%. This fantastic increase must have come as a result of a budget deficit - there had always been surpluses before - and a great increase in investment and demand for goods bought on hire purchase, which had been held up to a certain extent during the political uncertainty of 1962.

The result was a gradual rise in the discount rate. From 5.7% in 1962 it was 6.69% at the end of 1963, and had passed the 7% mark in 1964, thus reaching the levels of the very early 1950's.

In summary there are two points to make:

(i) the discount rate behaved as one would expect it to behave in response to economic circumstances.

(ii) its movements, conditioned by economic and political factors, though small and very gradual, certainly did not accentuate booms and recessions in the country. On the contrary, if they had any effect they were in the right direction, i.e. they ~~year~~ dampened down the fluctuations. It is a perfect example of a rate determined solely by the market forces and by competition.

CHAPTER III

THE LEBANESE ECONOMY AND THE FINANCIAL IMPLICATIONS OF THE PLANS FOR ITS DEVELOPMENT

The aim of this chapter is to discuss briefly some of the main characteristics of the Lebanese economy, the problems that fact it and how it is thought they should be tackled. Finally, the financial difficulties that may appear in the course of the development of the economy are considered.

I. The Lebanese Economy

"The Lebanese economy is as close to the classical 'Laissez-faire' model as one can expect in the modern world."[1]

> "Les opérations qui s'y réalisent, si elles ne peuvents être ni analysées ni comptabilisées, car leur caractère principal est d'être secrètes, sont nombreuses et porteuses de richesse, d'une richesse toujours renouvelée puisqu'elles doivent réussir en quelques heures, quelques semaines ou quelques mois, le long terme et le moyen terme semblant ici sans interêt."[2]

These two quotations summarise quite well the Lebanese economy because they bring out clearly the spirit of economic liberalism abd the mercantile character which have been its chief characteristics, and have actually helped to shape it in the form it is today.

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1. F.A.O. Mediterranean Development Project, Lebanon, Country Report, Rome 1959., Chapter I, p. 6.

2. Institut de Formation en Vue du Developpement, Le Liban Face à son Developpement (Etude IRFED) Beyrouth 1963, Imprimerie Catholique, p. 4.

There are unfortunately no reliable and official national income estimates for Lebanon, but a study undertaken at the American University of Beirut in 1952 estimated the national income to be £L1,115 million. The figure has been extrapolated since with, of course, a considerable and cumulative margin of error and in 1962 the estimate was £L1,650 million at 1954 prices.[1] A recent study of the national income of Lebanon published by the Ministry of Finance gives the following estimates:-

1961 - £L 1,789 million
1962 - £L 1,868 "
1963 - £L 1,951 "
1964 - £L 2,038 "

The study does not mention whether the estimates are at constant or current prices, but it says that they are based "on serious studies and not on official statistics".[2] If the above figure for 1964 is correct, the per capita income of Lebanon is £L 1,019 or $340 a year. However, some economists at the same Ministry believe these estimates to be too low and that in 1965 the national income was about £L 3,000 million.[3] If the latter figure is right, the per capita income is

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1. See Table XII for National Income estimates.
2. Ministry of Finance, Exposé des Motifs de la Loi de Finances pour l'Exercise 1966, Presses de la Direction Centrale de Statistiques au Ministère du Plan. Beirut.
3. Information received from private interviews with them.

£L 1,500 or nearly $500 a year[1] which places Lebanon in the intermediate stage of development according to the United Nations classification.

Recent estimates[2] of the contribution of the different sectors of the economy to the national income put services as the most important contributor and responsible for 70% of the total. Next comes agriculture with 18% and finally industry with 12%. Within the services sector, trade seems the most important item for, according to the American University estimates trade contributed 32% of the national income in 1962, and according to the Finance Ministry estimates its contribution was 25%. Whichever estimate is right it is still the largest contributor. The other main services are finance - thanks to the highly developed banking sector - insurance, transport and 'other services'.

The importance of the services sector can also be seen if one considers the balance of payments of Lebanon. In 1963, while imports stood at £L 1,179 million, exports were £L 323 million, leaving an

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1. There is no regular census of the population in Lebanon but the latest estimate of population based on the registrar for births and deaths is 2 million people.
   The U.S. dollar rate for the Lebanese Pound is 308 piastres for 1 dollar. (100 piastres to one pound).

2. Corm, G., 'Le Citoyen Libanais Face à Son Economie'. 3 articles in L'Orient, 3rd, 4th and 6th September, 1965. It is not mentioned which estimates of national income Mr. Corm used to obtain these percentage contributions of the different economic sectors, but as he works for the Ministry of Finance one can assume that he used the Ministry's figures.

adverse trade balance of £L 856 million.[1] In 1962 the deficit was £L 737 million and in 1961 £L 813 million. It is the net earnings from services estimated at £L 644 million in 1963, and £L 615 million in 1962 that covered the largest part of the deficit in the trade balance. Thus if one considers the balance of goods and services a deficit still appears but it is considerably reduced, as is shown in Table XIII: £L 219 million in 1963 and £L 130 million in 1962. Donations[2] and a net inflow of capital of £L 130 million in 1962 and £L 115 million in 1963 wiped out these deficits. Thus services do not simply contribute the largest part of the national income of the country; they are also a valuable source of the foreign exchange required to sustain the level of Lebanese imports. Moreover, the inflow of capital - mainly from the oil-producing countries of the Middle East - is clearly very important in the balance of payments. This capital is either invested in real estate and banking institutions, or simply deposited in the banks at sight or at short notice. Such deposits are quite large[3] and demonstrate the importance of the banking sector in the economy.

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1. A reservation should be made here in connection with the trade deficit. Lebanon receives a large number of Arab tourists who consume on the spot large quantities of the goods imported, or else take them back home, where import restrictions prevail. Such re-exports do not appear in the trade figures.

2. These came from Lebanese emigrants and are usually sent to their relatives still living in Lebanon.

3. See Chapter II page 86.

T A B L E   XIII

THE BALANCE OF PAYMENTS OF LEBANON 1960-63

CURRENT ACCOUNT

In £L millions.

Item	Credit				Debit				Balance			
	1960	1961	1962	1963	1960	1961	1962	1963	1960	1961	1962	1963
1. Merchandise trade	162	231	321	323	930	1,044	1,058	1,179	-768	-813	-738	-856
2. Non monetary gold	187	287	362	210	195	295	369	217	-8	-8	-7	-7
3. Foreign travel and Tourism	102	147			21	30			81	117		
4. Transportation and Insurance	119	153	758	799	13	31	143	155	106	122	615	644
5. Investment income	67	117			12	43			55	74		
6. Government not included elsewhere	57	74			5	7			52	67		
7. Miscellaneous services	172	209			-	11			172	198		
TOTAL GOODS AND SERVICES	866	1,218	1,441	1,332	1,176	1,461	1,570	1,551	-310	-243	-130	-219
8. Donations	107	128	110	121	2	7	12	12	105	121	98	109
Overall position on current account	973	1,346	1,551	1,453	1,178	1,468	1,582	1,563	-205	-122	-31	-110

Source: Khalil I. Salem, American University of Beirut. Unpublished.

For 1961 there is a new element called "errors and omissions" which just shows £L 43 million credit.

Why the Lebanese economy evolved that way is explained mainly by the pattern of natural resources with which the country is endowed - e.g. geographical location and climate - and which are more conducive to the promotion of services than to the production of goods. An experienced class of merchants entrepreneurs and bankers was thus created, increasing the trend towards such an economic structure. Moreover the economic policy pursued in the country ~~was~~ made for the promotion of trade and services. Agriculture and industry received very little government attention, whether through the pattern of government expenditure (emphasizing the development of an airport, ports, telephone services and the like, instead of agricultural and industrial development projects proper, like irrigation, power generating plants or state-promoted industries), through government trade policy (no protection to home produced goods but revenue tariffs only) or through monetary policy (complete freedom of exchange and capital movements). Lebanese economic policy has been very much influenced by the Liberal theories of the nineteenth Century, according to which the state should keep aloof from the economy doing the minimum required to keep security and order within the realm. The state was not to compete with private enterprise for the factors of production, nor was it to regulate the working of the economy. Activities undertaken by the state were in general considered to be less likely to be productive than those undertaken by private individuals. The pursuit of self-interest was widely believed to be conducive to the interest of all, and so it was believed in Lebanon.[1] So strong was this distrust of the State in Lebanon that public funds were considered as something that had better be kept in reserves lest they be wasted, and so, instead of following a strictly orthodox budgetary policy (by balancing its budget) as the adherence to government neutrality would imply, successive governments accumulated surpluses every year by not spending appropriated credits which then went into a Reserve Fund. The official reason was given in an interview which the then Director-General at the Ministry of Finance had with a newspaperman:

> "It may happen that the State is not equipped and does not possess an adequate administrative machinery to carry out all the expenditure necessary to the welfare of all. This had been the case in Lebanon..."[2]

That was the official reason: but if the need for such an administrative machinery had been felt, there was no reason why the State should not have got it. The result was a deflationary policy until 1962 irrespective

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1. The same sort of attitude seems to have prevailed in the United States in 1816-60: "Although the part played by the State and political institutions in this economic progress must not be overlooked, the policy of 'laissez-faire' and freedom of individual initiative was dominant at this time (1816-1860). Where individual enterprise seemed unable or unwilling to finance undertakings deemed of great importance the people fell back upon the resources and credit of the State now greatly strengthened, and without which many of the undertakings would have been impossible at the time." C.W. Wright, Economic History of the United States. McGraw-Hill Book Co. Limited, 2nd edition, 1949, p. 408.

2. Interview with Mr. A. Tueni, Director-General at the Ministry of Finance, now retired, L'Orient, 30th January, 1965.

of the economic conditions prevailing in the country, though perhaps inconsciously. Between 1943 and 1961 £L 497.5 million had been accumulated. No wonder it was said:

> "Although statistical studies are not advanced far enough yet to allow a mathematical study of economic cycles in Lebanon, one is not exaggerating when one affirms that without the dynamics of the private sector and especially the formidable expansion of the banking sector, the rate of growth of the [Lebanese] economy would have been much lower during all those years because of the financial policy of the State".[1]

However, in the late 1950's, despite the apparent prosperity of the country and especially relatively to most of the immediate neighbours which adopted socialism and a larger amount of State control, extreme economic liberalism was being questioned, and the weaknesses of the Lebanese economy were pointed out. The weaknesses were seen with regard to the future development of the economy and the question was whether what was called the "Lebanese economic miracle" would continue, and whether it was not preferable to change the bases on which the economy rested before it was too late. This meant a change of attitude towards the economy. What led to this change was an awakening to the new conditions that were going to face Lebanon in the future and which were already making themselves felt. Changes were occurring both at home and abroad, and especially

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1. Corm G.,"Bilan des Finances Publiques Libanaises 1945-65", Le Commerce du Levant, Yearly Supplement, 3rd March, 1965. Translation is mine.

in the Arab world from which Lebanon derived a large portion of its national income. So the question was whether the Lebanese economy could continue to prosper under the new conditions with the same spirit of extreme 'laissez-faire' that characterised the past. This question called for an analysis of the weaknesses of the economy.

Much criticism has centred around the dominant role of services in both the national income and the balance of payments. The economy is found to rely too heavily on that one sector alone which after all depends so much on factors outside the Lebanon. The abstract form of this argument, namely that the economy must be diversified, because a slump in that one sector alone could cripple the economy, is put forward, but it cannot be used as a proof of weakness in the Lebanese economy. Most economies rely more heavily on one type of activity than another: Venezuela on Oil, Britain and the United States on the motor car industry. In all these economies a slump in that one activity could seriously disrupt the economy.

A similar argument is that the future of the services sector is very uncertain and that it would be unwise to go on relying on it to provide a large proportion of the national income and enough capital to finance the trade deficit. This argument could be pointing to a weakness in the economy if by it was meant that Lebanon should not go on relying on the same services and especially to the same countries as in the past. The main recipients of these services have been the neighbouring countries which are changing their economic systems - e.g. Syria, Iraq - and tend to provide these services for themselves, thus bypassing the Lebanese intermediary. A typical example is the use made of the port of Beirut: formerly the largest part of the Syrian and Jordanian trade with the West used to transit in Beirut; Jordan now restricts all her imports to her port of Aqaba, while Syria restricts hers to her port at Lattaquieh, and goes further by putting great difficulties on goods in transit between Beirut and Iraq.

But so far this weakness has not been serious, for, in spite of difficulties encountered in some of the traditional services provided, the services sector - excluding tourism - has been financing a larger part of the deficit in the balance of trade. Thus in 1960 the balance of total goods and services (Table XIII) showed a deficit of £L 310 million. In 1961 the deficit was reduced to £L 243 million and in 1963 to £L 219 million in spite of the increased trade deficits.[1] This shows that the services sector is highly adaptable and flexible, and that as conditions changed and certain services slackened or became

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1. 1962 was rather exceptional as economic activity declined in that year. As a result imports which are linked to it rose very little. Exports continued to rise and the trade deficit was reduced from £L 813 m. in 1961 to £L 738m.in 1962.

difficult to provide, others were offered. Unfortunately, it is not possible to say which declined and which were introduced, as statistics are not detailed enough on this subject. But one can say with some certainty that the growth of banking[1] and finance must have offset the decline in other services.

Therefore the heavy reliance on one sector has not so far proved to be a major weakness in the Lebanese economy, for, as conditions changed, far from declining in importance, this sector has in fact increased in importance thanks to its adaptability.

Recently, discussions on the Lebanese economy have centred around the social problem that seems to have arisen as a consequence of its structure. Such discussions have pointed to two major weaknesses: the sectoral distribution of income and the ability of the economy to provide employment for all the Lebanese who will be seeking work in the future.

The sectoral distribution of income in Lebanon was one of the main weaknesses pointed out by the IRFED mission.[2] Except for 1958 the

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1. Described in Chapter II.

2. In March 1959 Président Chehab of the Lebanon asked the Director of the Institut de Recherches et de Formation en vue du Developpement (IRFED) in Paris to set up a technical mission whose terms of reference were to undertake a general study of the situation and needs of the Lenanon, and to make recommendations on the possibilities of economic and social development. The Government appointed the mission officially in September 1959. It reported first in October 1960 and then in May 1961.

national income of Lebanon grew throughout the period 1950-64, but its expansion has been largely limited to the tertiary sector of the economy, i.e. the trade and services sector. Thus oriented, the expansion intensified a disproportion in the distribution of income and employment in the economy. While trade and services account for 70% of the national income, agriculture 18% and industry 12%, the first employs only 38% of the working population, agriculture employs 50% and industry 12%. Thus productivity and incomes are very low in agriculture and much above average in the tertiary sector, while in the industrial sector they are about average. However, the IRFED Mission claimed that industry's record could certainly be improved.

The great accumulation of wealth in the tertiary sector which is active mainly in Beirut and around it, has led to the geographical maldistribution of income in the country, and as pointed out in the IRFED Report there is a wide gap between the standard of living in Beirut and that in the country. Beside the problem of income distribution, the very heavy concentration of activity and wealth in Beirut has led to:

i. an overcrowding of the city where amenities were not conceived for such a large population

ii. great differences in educational, sanitary and leisure conditions, as everything has had to be done in Beirut first.[1]

1. More details of this point can be found in the IRFED Report, Le Liban Face à Son Developpement, op. cit. pp. 145-175

iii. a depopulation of the countryside

Had the State realised ten to fifteen years ago that it could intervene in the economy to modify these tendencies, Lebanon might have had a more equitable pattern of income distribution to-day. But the 'laissez-faire' attitude described earlier in the chapter was too deeply entrenched in people's minds for anything like that to happen. However, it is now realised that the problem of income distribution is one in which the State has a role to play, and a new attitude towards its responsibilities has thus emerged.

This new attitude has been strengthened by still another factor, namely the employment problem that Lebanon may have to face in the future. Although no proper population census has been undertaken in Lebanon since 1931, it is estimated that the working population which numbers now about 500,000 people, should reach the million mark by 1980. This means that the number of jobs will have to be doubled in about fifteen years. The problem is sometimes minimised with the suggestion that, as in the past, emigration will act as a safety valve. It is doubtful, however, whether emigration will occur at the same rate as in the past as the countries to which Lebanese used to emigrate are becoming increasingly difficult over immigration.[1] Thus the problem of

1. This is particularly the case in West Africa where there is what is called a 'Lebanese problem'. For details of this problem in Sierra Leone see "Tensions Persist in Sierra Leone" The Times, 6th May, 1964, p. 13.

employment may become acute if nothing is done about it, and it is one of the reasons why a new attitude towards the economy and the role of the State in it has developed. It is now realised that the foreign sector is prospering and that obviously Lebanon has a comparative advantage in it. But it is also believed that agriculture and industry can develop in the future in a way that would solve the social and employment problems without affecting the foreign sector, which implies that if such a development does not take place the economy would be working at sub-optimum levels. It is with this in mind that plans for the economic development of Lebanon have been put forward.

II Plans for the Economic Development of the Country

This section will deal with how it is thought the Lebanese economy should develop to help resolve the social and employment problems that face it and with the financial difficulties of such development. At the moment the official policy towards the economy in Lebanon is that while agriculture and the tertiary sector should be strengthened and improved, industry is the sector that should be relied upon to provide enough jobs for the future and to modify the sectoral maldistribution of income. This policy was adopted after an analysis of the potential growth of each sector.

Taking agriculture first, on the one hand land tenure by small holdings reflected by the very low employee to employer ratio (0.76 in Table XIV), prevails in Lebanon, and on the other hand, it is estimated at the Ministry of Agriculture that only 350,000 hectares of land can be cultivated in Lebanon; this is not very much more than the 325,000 hectares which, according to the same source, are cultivated now.

TABLE XIV

COMPARISON OF EMPLOYMENT IN INDUSTRY, COMMERCE & AGRICULTURE

Nature of activity	Employers (including self-employed)	Employees	Ratio Employee/Employer
Agriculture	125,000	95,000	0.76
Industry Handicraft Construction	12,000	75,000	6.2
Transport Commerce Banking	26,000	53,000	
Other services	20,000	28,000	1.7

Source: IRFED Report

It is therefore thought unlikely that agriculture will help much in the provision of enough jobs to employ a sizeable proportion of the extra working population in the future. However, agricultural development can help to improve the conditions of those already on the land and it is with this in mind that development plans for that sector have been put forward.

Secondly, the tertiary sector is not expected to solve satisfactorily the employment and social problems thought likely to arise in the future. This sector is composed mainly of self-employed as the employee to employer ratio (1.7) in Table XIV shows. The importance of self-employment in this sector is further shown by the relatively low proportion of wages and salaries in the income generated within the sector - it does not exceed 10% compared to 36% in industry.[1] On the other hand trade and services are already quite developed as shown above and it is therefore thought doubtful that a large enough expansion of this sector would take place to provide the jobs necessary to employ the extra working population that will appear. Moreover, even if it were possible for that sector to employ the bulk of the extra labour becoming available, which would help to solve the employment problem, it would not help to solve the social problem. Expansion of this sector would imply the accumulation of more wealth in and around Beirut: far from solving the present geographical maldistribution of

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1. Gannagé E. 'La redistribution des revenus au Liban', in Semaines Sociales de Beyrouth, 1955.

income and the social problems it raises, such an expansion would accentuate it. But here again this sector should not be neglected because as shown earlier, services pay for a large part of the deficit in the trade balance and they have proved themselves highly adaptable to the changing economic conditions. Services are still very lucrative and should be given the opportunity of staying so.

Industry is thus thought to be the most likely sector to help in the solution of the problems set out above. The employee to employer ratio estimated to be 6.2, is highest in industry. Compared to developed countries, the figure may seem low, but it must not be forgotten that industry is relatively new in Lebanon - mainly since the Second World War[1] - and that on the whole, firms still tend to be of small to medium size as is evidenced in Table XV. Not only are there possibilities of new industries being created but also of expanding existing ones.

An expansion of the industrial sector would then be likely to provide exployment for the future expected labour increase, and permit a better distribution of income both structurally and geographically, as investment would not then be concentrated in Beirut since the location of industry can be more easily diversified than that of services.

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1. See Table XVII below

TABLE XV

INDUSTRIAL CENSUS FOR 1955 IN LEBANON

Description and number employed	Number	% of total number	Turnover in £L.m.	% of turnover	Turnover plus stocks £L.m.
Small handicrafts 5 - 9 persons	1031	56	45.7	11	63.5
Large handicrafts 10-25 persons	581	31	74.9	19	101.7
Small firms 26 - 50 persons	149	8	63.9	15	82.8
Medium firms 51 - 100 persons	60	3	46.0	11	62.2
Large firms over 100 persons	40	2	168.9	44	243.9

Increasing productivity in agriculture to improve the standard of living in that sector, strengthening the tertiary sector where services are essential to the economy, and developing industry to help Lebanon face up to the problems that may arise in the future: these are in broad terms the paths along which it is thought desirable that Lebanon should develop. In all this the State has a new role to play and a plan has been prepared with this in mind.[1] What should be considered now

1. It is interesting to note that in the United States the shift away from laissez-faire was also caused by social reasons in the second half of the nineteenth century. See C.W. Wright, op. cit. pp. 715-17.

are the credit problems that may arise if this programme is to be fulfilled.

1. Agriculture

The IRFED Mission which undertook a study of agriculture in Lebanon as part of its survey of the Lebanese economy put forward various suggestions to increase the revenue from land and thus bridge the gap between the rural and urban standards of life. Both public and private sectors have responsibilities in this direction, the public sector concentrating more on infrastructural projects - irrigation, education, communications - and the private sector being more directly concerned with the reconstitution of land for improvement, the setting up of co-operatives, slaughter houses, wholesale markets and regional credit institutions. All these responsibilities involve considerable investment and the problem is whether the necessary types of credit are available to carry them out. Whether the State has access to the types of credits which it would require is considered in a later section. The credit problems of the private sector are here considered.

The IRFED Mission estimated that the private agricultural sector would require about £L 65.7 million - over 50% of the total outstanding debt of the agricultural sector to commercial banks in

December 1964 - in the period 1964-68 for the purposes defined above. Details of the estimate, which refers only to new investments, thus excluding credits now available to the agricultural sector which will show an increase of their own, are shown in Table XVI. But the most important thing is that these funds would have to be available on medium- and long-term and the problem now is whether the agricultural sector is able to generate these funds within itself and failing self-finance, whether these medium- and long-term credits could be made available by credit institutions.

It is generally thought doubtful that the agricultural sector could generate the funds required for its development and the main reason given is that the farmers' incomes are on the whole too low to leave any appreciable surplus for investment.[1]

The poverty of the sector is evidenced by the average income in agriculture, which, as noted above is much lower than the national average income. The incomes of farmers are often increased by remittances from parents and relatives living in towns or abroad:

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1. Nasrallah P., Le Crédit à Moyen Terme au Liban, Librairie Générale de Droit et de Jurisprudence, R. Pichon et R. Durand-Auzias, Paris, 1961 pp. 94-98.
   IRFED Report, Le Liban Face à Son Developpement, op. cit., p. 230

TABLE XVI

ESTIMATES OF MEDIUM & LONG-TERM CREDITS NEEDED BY THE AGRICULTURAL SECTOR

In £L thousands

USE	1964	1965	1966	1967	1968	TOTAL
Reconstitution of land for improvement	1,000	2,000	3,000	4,000	4,000	14,000
Acquisition of property	1,000	3,000	6,000	10,000	20,000	40,000
Credit to Co-ops.	-	20	40	60	80	200
Slaughter Houses and wholesale markets	2,000	2,000	-	-	-	4,000
Credit institutions	-	500	1,000	2,000	4,000	7,500
TOTAL	4,000	7,520	10,040	16,060	28,080	65,700

Source: IRFED Preliminary Report: Besoins et Possibilités de Developpement au Liban, (2 vols.) Helio Electronic Press, 1960-61. These estimates do not include the credits to the private sector needed for the carrying out of the 'Green Plan' project - the reforestation of the country - which was prepared by the Ministry of Agriculture.

> "It is particularly rare to discover farmers in Lebanon who do not have some connection with other activities in the country, and from which they do not derive a part of their revenue".[1]

But, as Mr. Nasrallah mentions, such revenue merely complements income derived directly from agriculture and helps to keep the "farmer's head above water level".[2]

So the farmers will have to be provided with medium- and long-term credit if the official development plan for agriculture is to be carried out. At the moment there are three sources of credit in the agricultural sector: the family and acquaintances, commercial banks and the Banque de Credit Agricole Industriel et Foncier (BCAIF).

Credits granted from the first source are not well known, but when they are granted it is often not on any economic basis, but more on a family or religious basis. Such credits are a transfer of funds between sectors because the funds usually come from relatives or acquaintances working in industry or in towns or even abroad. Although the granting of such credits is supposed to be based on a spirit of solidarity, interest rates are generally believed to be quite high and especially when they originate not

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1. Saadé F., Semaines Sociales de Beyrouth, 1955. Translation is mine.
2. Nasrallah P., op.cit., p. 96. Translation is mine.

from relations but from acquaintances. In this latter case the rate may reach 10% per month.[1]

Commercial banks grant some short-term credits to farmers. Unfortunately, not much data are available to show the growth of these credits. The only figure that is known relates to December 1964 and amounts to £L 124.216 million.[2] These credits are usually given for nine months and are used for current production. The rate of interest charged varies between 10 and 12%[3] a year.

The B.C.A.I.F. described in an earlier chapter is empowered to give medium- and long-term credits. Its total credits to agriculture - including short-term - amounted to £L 27 million in 1955 which represented a tenfold increase over 5 years earlier. The rate of interest charged - 5½% - is quite low relatively to the banks' advances rates in Lebanon.

Finally credit is also available from merchants who sell seeds, fertilisers and insecticides, and who grant some short-term credit facilities to the farmers at rates varying from 10% to 18% a year. It is not known exactly how much is granted this way but it is estimated to be in the region of £L 15 to £L 20 million a year.

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1. Source: IRFED Report, Le Liban Face à son Developpement, op. cit. p. 230.

2. Source: Bank of Lebanon, Annual Report 1964

3. The maximum legal rate in Lebanon is 9%. But commissions and expense charges raise the effective rate.

So at present the only significant source of medium- and long-term credit available to farmers is the B.C.A.I.F. Family acquaintances and merchants can hardly be relied upon to grant such credits in the amounts thought to be required and at reasonable rates of interest. Commercial banks are reluctant to lend on longer than short-term bases, partly because the risks of lending to poor farmers - who in fact are in majority in the agricultural sector - are too high; this is one of the reasons why money lenders charging exorbitant rates of interest can flourish. As to the B.C.A.I.F. it has proved to be totally inadequate, to the requirements of agriculture. Its resources are very limited[1] and are not easily expandable; it is not present in many regions of the country, and besides, it is believed that only the few wealthy landowners have been able to get assistance from it.[2] Agriculture will thus lack the medium- and long-term credits that will be necessary to carry out the development plan that has been envisaged for it. It may seem strange that in view of their liquidity, and the fact that they still compete for deposits, banks are not prepared to grant such credits and face the risks involved, or that special institutions have not grown to meet the demand. This is a point which will be encountered many times and which will be

1. See Chapter II, p. 105

2. IRFED Report, Le Liban Face à son Developpement, op. cit., p. 230

discussed in detail in the following chapter. The main reason is, briefly, that banks and any financial institution can always invest abroad what they cannot invest in Lebanon at a satisfactory degree of risk or rate or return.

Therefore if agriculture is to receive the medium- and long-term credits that it will require to develop along the path set for it, new institutions will have to be brought into being, or new conditions will have to emerge to induce existing credit institutions to provide them. How could this be done is considered in the next chapter.

So far, we have discussed the credit requirements of agriculture with regard to the development plan. There is one important aspect still missing, namely, the adequacy of the short-term credits which are now available to this sector. These credits, which are granted by commercial banks for nine months, are used for current production. According to a report at the Ministry of Planning[1] the nine months period is not long enough for the produce does not appear on the market within that period. The result is that the producer often has to repay his loans before or while he is selling his produce. According to the same report, this has often resulted in considerable financial pressure on the producer and that is

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1. Republique Libanaise, Ministère du Plan, Projet pour le Création d'und Banque de Developpement, Typescript, 1963.

another reason why he has to resort for a short time to money-lenders who charge high rates of interest. The same report recommends that an extended short-term credit be made available to improve the conditions of the farmers and the period suggested is eighteen months. Thus it seems that all types of credit will have to be made available for agriculture.

Before leaving this section it might be useful to show the urgency of adequate credit facilities to farmers by quoting Mr. Nasrallah and the IRFED Mission:

> "This lack of credit is at the same time the cause and consequence of poverty, it is the cause in so far as the farmers lacking liquid money, are unable to invest in the land. It is also a consequence or a symptom of poverty because a high rate of interest and heavy indebtedness are signs of a chronic insufficiency of the farmers' incomes and of a permanent tendency for their consumption to exceed their production."[1]

The lack of credit is

> "killing the farmers' initiative, leading to emigration and even provoking the abandonment of land."[2]

2. Industry

Although industry contributes 12% to the national income of Lebanon and £L 840 million are invested in it, it is of very recent origin, its history going back over a very few decades only as can be seen in the following Table:

1. Nasrallah P., op. cit. pp 97-98. Translation is mine.
2. IRFED Report, Le Liban Face à son Developpement, op. cit., p. 230 Translation is mine.

TABLE XVII

Firms which in 1955 were less than	Cumulative Number	Cumulative Percentage
5 years old	430	23%
10 years old	830	44%
15 years old	1,030	57%
22 years old	1,370	75%
32 years old	1,570	85%
42 years old	1,861	100%

Source: Compiled on the basis of the industrial census of 1955[1] by Mr. P. Nasrallah, Le Credit à Moyen Terme au Liban, op. cit. p. 116.

Its growth has not been easy. It encountered many difficulties before the Second World War from the French occupants who, it is claimed,[2] were busy trying to sell French products. But in 1945 industry received a new impetus: independence[3] and large capital profits made during the War from appreciation of stocks, encouraged Lebanese businessmen to create new industries. As they grew,

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1. There has not been an industrial census in Lebanon since. The Industrial Association estimated that there were 6,000 firms in 1965. See Le Commerce du Levant Yearly Supplement, 3rd March 1965.
2. Nasrallah, P., op. cit., p. 116.
3. Independence was granted in 1943 but foreign troops did not evacuate the country before the end of the War.

difficulties started appearing, some of them common to other under-developed countries, others peculiar to the Lebanon. Among the first there is the problem of an infant industry still relatively inexperienced and too small to reap the economies of large scale production. Moreover, Lebanon is not yet adequately equipped with all the basic services that the State usually provides and which industry often has to provide for itself.[1] That is one of the reasons why industrial activity tends to be concentrated around Beirut where these basic services are relatively easier to acquire but which accentuate the geographical maldistribution of wealth in the country. Costs are therefore high and furthermore local production is not protected against foreign competition - which is a difficulty particular to Lebanon rather than to all under-developed countries. Tariffs are raised for revenue rather than for protection. The reason is the belief in complete 'laissez-faire' which was described earlier in the chapter and the fact that that policy has been very successful and lucrative in the past. The result is that Lebanese industry has had to face from its earliest stages very stiff competition from abroad and in an already very small market.

But the attitude towards industry has changed recently with

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1. A typical example is a firm just outside Beirut which has to have its own power generating units, its own water wells and many messengers because it cannot rely on constant and efficient electricity and water supplies and on a proper and efficient postal and telephone service.

the new approach to the economic problems of Lebanon. As noted earlier industry is now looked upon as the sector that is most likely to absorb the working population increase, and there are plans for its development involving responsibilities for the State and the private sector although the responsibilities of the latter are not as clearly defined as for agriculture.

Apart from fiscal policy, the State's responsibilities are here again mainly related to infrastructural projects; these should improve the provision of basic services to industry and should help them to reduce their costs. Such projects include the provision of electricity, transport facilities and technical colleges, also involving heavy investment the financing of which is considered later. As regards the private sector it is hoped that existing industries will complete their capital equipment, modernise and scrap obsolescent machinery, and adapt themselves to modern lines of production - for example a textile business moving away from cotton into man-made fibres. It is also hoped that the industrial sector will expand by the creation of new industries in all parts of the country. This will increase further the number of jobs that will become available, and will relieve the increasing pressure from Beirut.

From private interviews with businessmen it seems that the official policy is well supported, and given that the State is prepared to adopt a more positive policy towards industry - which again seems probable now - the problem will be that of finance. Industrialists complain about the lack of medium- and long-term credits in Lebanon; their Association lists the absence of such credits as one of the difficulties that they have to fight.[1]

The non-availability of such credits to industry from banking institutions was discussed earlier.[2] Why banks do not do better in the provision of such credits when there seems to be a demand for them is again partly due to the competition of foreign investment as will be explained in the next chapter. The capital market is inadequate. On the supply side, people at large are afraid of the wild speculation that takes place; it was recently reported that:

> "the present crisis at the Bourse is primarily one of confidence: the fancy and authoritarian behaviour of large holders, the lack of an official control when the rules are breached every day do not encourage the small savers who

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1. "L'Industrie Libanaise, Espoir d'un Avenir Prospère", <u>Le Commerce du Levant</u>, Yearly Supplement, 3rd March, 1965. Also in a letter to the Prime Minister on 10 Jan. 1966, reproduced in <u>Le Commerce du Levant</u>, 5th March, 1966.

2. See Chapter II pp. 105-06

> do not 'play (speculate) at the Bourse', and who consequently are alone able to provide the market with the stability that it needs ..."[1]

The political atmosphere in the Middle East also has caused large speculative movements in the past.[2] On the demand side it must be realised that industry is of recent origin in Lebanon and that firms on the whole started as private companies relying mainly on self-finance. Where public companies were created entrepreneurs preferred to keep the shares within the family or very close friends, and so on the one hand did not sell their holdings in the Bourse and on the other never liked to nor did divulge much details about their activities or their balance sheet positions. This last factor was important in deterring small investors from entering the market.[3] This has also meant that there are very few companies which are actively traded, and

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1. Extract from <u>L'Orient</u> June 7th 1965. Translation is mine. The growing disinterest in the Bourse and its speculative character are clearly shown in the fluctuation of the volume of business in the years 1960-65: 1960: £L. 65 m. 1961: £L. 72.5 m.
1962: £L. 28.5 m. 1963: £L. 75 m.
1964: £L. 71.4 m. 1965: £L. 30 m.

2. For details see R. Pringuey, <u>Le Marché des Valeurs Mobilières à Beyrouth</u>, Thesis for a 'Doctorat' submitted at the Faculté de Droit et des Sciences Economiques de Beyrouth, Imprimerie Catholique, 1959, pp. 121-130.

3. This point is immediately apparent to anyone who conducts business in Beirut and was discussed in an article by C. Toma, 'Les Causes Profondes du Marasme à la Bourse de Beyrouth', <u>L'Orient</u>, 10th February, 1966, p. 12. See also <u>L'Orient</u> 5th February, 1965

given the very large amount of money in Lebanon seeking investment opportunities[1] a very disorderly capital market ensued.[2] This has further encouraged small savers from entering the capital market and instead they invest in tangible, safe and unproductive assets such as real estate, or else are content to deposit their money in the banks. There is thus a climate of distrust and apprehension at the Bourse which, even if a re-organisation of the exchange was carried out, would take a long time to disappear. Therefore, entrepreneurs would still have to fall back on self-finance or on a renewable three monthly credits when in need of medium- or long-term credits, unless other institutions were created to provide them. The kind of institution that could be created is discussed in the next chapter.

Before leaving this section the hotel industry should be mentioned. A study conducted at the Ministry of Planning,[3] has shown that it is essential for tourism that credit facilities be

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1. See Chapter II
2. See R. Pringuey, 'La Bourse de Beyrouth: Perspectives d'une Nouvelle Reorganisation', L'Orient, 16th December, 1965. It is the 3rd of 4 articles. One of the examples he gives is that of the Compagnie Libanaise des Pētroles which since 1957 has been responsible for 40% of all dealings on the floor of the Bourse.
3. Projet pour la Création d'une Banque de Developpement, op. cit. The importance of tourism and especially of hotels and their need for medium-term credits were recently stressed by Gannagé E.,"Besoins et Objectifs du Developpement Economique", L'Orient, 22nd 23rd April, 1966.

made available. At present, apart from self-finance, the only sources of finance available are the banks, which are willing to grant three monthly credits and the B.C.A.I.F. which earmarks £L 4 million a year for new loans to hotels. Only the B.C.A.I.F. is willing to extend medium-term credits, and for reasons already discussed it is not able to be of much help.

According to the same report, three types of credit are required:

i. short-term credits up to nine months to help mountain hotels, where work is highly seasonal, in the trough months,

ii. medium-term credits to modernize and expand existing hotels,

iii. long-term credits, to open new hotels. These are considered essential if, as is hoped, there is going to be an expansion of tourism. As commercial banks are again not ready to grant medium-term credits other institutions have to be created.

3. <u>The public sector</u>

> "It is a society in transition, dominated still by an intense individualism..."[1]

1. IRFED Report, <u>Le Liban Face à son Developpement</u>, op. cit. p. 3. It is the opening sentence of the report.

This quotation reflects quite accurately the attitude in Lebanon towards the economy. It is in transition for, as explained earlier, a new approach in the study of the Lebanese economy has shown the possibility of problems arising in the future and in which the State has a major responsibility. Various reports and studies on the Lebanese economy have thus underlined the necessity for the State to intervene in the economic life of the country, but at the same time have stressed the importance of liberalism and 'laissez-faire'. This explains the latter part of the quotation. The importance given to liberalism is dictated by the fact that it is still deeply entrenched in the people's minds and that any sudden and violent change of economic policies would change the expectations of many Lebanese and foreigners, and might undermine confidence in the country's stability.[1] Thus one can read Professor Bourguinat who speaks of the narrow path ('voie étroite') of the Lebanese economy which consists in nursing confidence while at the same time endeavouring to re-adjust the economy to modern conditions.[2] This point is also emphasised by the IRFED Mission

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1. The importance of liberalism in the Lebanese economy was stressed again recently by Mr. P. Eddé who is a former Minister of Finance and the President of Lebanese Banks' Association (ABL) and a banker himself. See his article in L'Orient, 21st April, 1966.

2. Professor H. Bourguinat, 'Regards sur l'Economie Libanaise', L'Orient, 9th, 10th and 11th June, 1965.

which said that:

> "State planning has to be original and adapted to the Lebanese reality, allowing the State to intervene directly only in the field of infrastructural investments, and in the establishment of the ruling and administrative machinery; it is with tariffs and financial incentives that the State should encourage the individual man to co-operate in the economic development designed to achieve an optimum use of the soil, an expansion in industry, handicrafts and tourism, all of which are here [in Lebanon] sources of a prosperous and adapted economy."[1]

This attitude towards the State explains why for agriculture and industry, its responsibilities were mainly concerned with the provision of infrastructural equipment. The State is no more simply an Etat-Gendarme: it is to create those conditions under which private enterprise and the economy can prosper and develop. It is with this in mind that the five year plan 1964-68 was prepared, and to which we turn now to try to find out what financial problems may face the public sector in the future so that we may discover what a Central Bank could do in this direction. Details of the plan and statistics relating to it were privately secured from an unpublished report prepared by the Planning Commission for the Ministry of Finance in 1964-65, and from private discussions with a member of the Commission.

A. <u>State Expenditure</u>

State expenditure is divided into two main parts:

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1. IRFED Report, <u>Le Liban Face à son Developpement,</u> op. cit., p. 6.

a. 'Budget de fonctionnement' or ordinary budget.

b. Development Budget.

The emphasis on development projects, which reflects the new attitude to the economy discussed above, will clearly emerge.

a. Ordinary budget

In the four-year period 1960-63 the ordinary budget increased on average by 15.8% a year. This is not expected to continue in the future because in that period the State was widening its range of activities very rapidly and had to increase its expenditure at a very high rate. In the five-year plan a levelling off is expected and two alternatives are put forward. One is given by the Finance Ministry and it plans for a 9.5% annual increase in the ordinary budget. This would mean a total of £L 2,057 million earmarked in the 1964-68 plan for the ordinary budget alone. The Planning Commission finds this rate rather excessive and suggests instead a 6% annual increase which it thinks possible if a higher productivity and more efficiency can be secured from the administration. If the Commission's rate was adopted the ordinary budget would absorb £L 161 million less than it would if the Finance Ministry's estimate prevailed.[1] Details are shown in Table XVIII below.

1. At the time of writing no decision has apparently been made.

From £L 336.5 million in 1964 the ordinary budget is estimated to reach £L 424.85 million in 1968.

TABLE XVIII

STATE EXPENDITURE IN THE FIVE YEAR PLAN 1964-68

in £L millions

Planning Commission hypothesis of 6% yearly increase in ordinary budget.

Type of expenditure	1964	1965	1966	1967	1968	Total
A. Budgetary Expenses						
Ordinary Budget	336.50	356.70	378.10	400.75	424.85	1,896.90
Development budget	148.60	128.30	136.60	124.10	133.95	671.55
Total A	485.10	485.00	514.70	524.85	558.80	2,568.45
B. Treasury Advances	92.00	48.50	21.00	20.00	15.00	196.50
TOTAL A & B	577.10	533.50	535.70	544.85	573.80	2,764.95

Source: Planning Commission Report to the Ministry of Finance, 1964-65 Unpublished.

b. Development budget

The Development budget is divided into two parts: One that has already been approved and another that is new and has not yet been adopted.

There seems to be a disagreement over the cost of the projects that have been approved. While the IRFED Mission estimates they would cost £L 584.9 million (£L 459.7 million if Treasury advances are excluded), at the Ministry of Finance it is expected that they would cost £L 868.05 million (£L 671.55 million if Treasury advances are excluded)[1]. Details of the Treasury advances as conceived by the Finance Ministry are shown in Table XIX. Details about the IRFED estimate of the cost of the approved projects can be seen in Table XX - which gives the absolute amounts - and Table XXI - which gives the percentages. Table XXII shows the details of the approved projects as conceived by the Finance Ministry, which is confident that its estimate is the right one, and which therefore we shall adopt later.

The new projects plan submitted by the IRFED Mission and which is expected to cost £L 568.8 million (Table XX) complements the approved projects but places a heavier emphasis on social

1. The two sets of figures are not strictly comparable as the latter include certain amounts earmarked for social and cultural subsidies. But even if these are excluded the latter set is higher.

T A B L E XIX

TREASURY ADVANCES IN £L MILLIONS

Item	1964	1965	1966	1967	1968	Total
Army Cooperatives	3	2	1	-	-	6
Litani Project	31.5	6.5	-	-	-	38
Autonomous agencies	2	2	2	2	2	10
Railways, Buses	10	2	-	-	-	12
Port of Beirut	16	16	-	-	-	32
Government City	10	4	-	-	-	14
Electricity	-	10	10	10	5	35
Green Plan	2	4	6	6	6	24
Fruit export co.	5	-	-	-	-	5
Staff indemnity	8.5	-	-	-	-	8.5
National Development Bank	2	-	-	-	-	2
TOTAL	90.0	46.5	19	18	13	186.5
Miscellaneous	2	2	2	2	2	10
TOTAL	92	48.5	21	20	15	196.5

Source: Planning Commission Report to the Ministry of Finance.

TABLE XX

DEVELOPMENT PLAN PROJECT (1964-1968)

PLAN OF PUBLIC EXPENDITURE INCLUDING TREASURY ADVANCES (In £L millions);

	APPROVED PROJECTS						NEW PROJECTS						TOTAL					
	1964	1965	1966	1967	1968	TOTAL (A)	1964	1965	1966	1967	1968	TOTAL (B)	1964	1965	1966	1967	1968	TOTAL (A)+(B).
I. INFRASTRUCTURAL EXPENDITURE																		
a) Economic Infrastructure																		
Roads	33.360	30.150	32.650	24.100	12.940	133.200	-	8.860	8.780	18.080	29.480	65.200	33.360	39.010	41.430	42.180	42.420	198.400
Drinking Water Ducts	22.574	24.800	18.600	1.226	-	67.200	-	140	205	10.155	10.125	20.625	22.574	24.940	18.805	11.381	10.125	87.825
Irrigation	13.134	15.249	15.163	1.597	1.063	46.206	1.100	10.400	12.445	23.445	24.404	71.794	14.234	25.649	27.608	25.042	25.467	118.000
Electricity [1]	46.900	21.200	23.900	12.000	11.000	115.000	-	6.375	6.475	20.110	17.510	50.470	46.900	27.575	30.375	32.110	28.510	165.470
Municipal	-	-	-	-	-	-	640	740	790	940	990	4.100	640	740	790	940	990	4.100
Communications	23.867	19.177	1.232	1.208	-	45.484	2.000	2.000	3.000	9.000	9.000	25.000	25.867	21.177	4.232	10.208	9.000	70.484
Buildings	28.755	16.633	7.404	1.160	-	53.952	-	-	-	7.048	8.000	15.048	28.755	16.633	7.404	8.208	8.000	69.000
Miscellaneous equipment [2]	7.925	9.647	10.672	-	-	28.244	-	-	-	-	-	-	7.925	9.647	10.642	-	-	28.244
Total (a)	176.515	136.856	109.621	41.291	25.003	489.286	3.740	28.515	31.695	88.778	99.509	252.237	180.255	165.371	141.316	130.069	124.512	741.523
b) Social Infrastructure																		
Health	-	-	-	-	-	-	2.825	7.872	10.494	13.497	17.512	52.200	2.825	7.872	10.494	13.497	17.512	52.200
Education	3.809	1.239	- -	-	-	5.048	6.561	19.069	27.933	38.878	41.656	134.097	10.370	20.308	27.933	38.878	41.656	139.145
Antiquities	2.000	2.000	2.000	-	-	6.000	1.381	1.550	1.550	3.100	3.254	10.835	3.381	3.550	3.550	3.100	3.254	16.835
Social Security	650	12.000	16.000	16.000	16.000	60.650	-	-	-	-	-	-	650	12.000	16.000	16.000	16.000	60.650
Technical Training	-	-	-	-	-	-	43	281	331	177	335	1.167	43	281	331	177	335	1.167
O.D.S [3]	-	-	-	-	-	-	3.106	4.962	7.014	7.033	8.391	30.506	3.106	4.962	7.014	7.033	8.391	30.506
C.N.R.S.	1.000	1.500	1.500	2.000	2.000	8.000	-	-	-	-	-	-	1.000	1.500	1.500	2.000	2.000	8.000
Total (b)	7.459	16.739	19.500	18.000	18.000	79.698	13.916	33.734	47.322	52.685	71.148	228.805	21.375	50.473	66.822	80.683	89.148	308.503
TOTAL (I) = (a + b)	183.974	153.595	129.121	59.291	43.003	568.984	17.656	62.249	79.017	151.463	170.657	481.042	201.630	215.844	208.138	210.754	213.660	1,050.026
II. DIRECTLY PRODUCTIVE ACTIVITIES																		
Agriculture	2.821	3.072	3.096	2.791	2.750	14.530	2.644	6.525	6.534	6.291	8.766	30.760	5.465	9.597	9.630	9.082	11.516	45.290
Fisheries	-	-	-	-	-	-	950	1.050	1.050	850	350	4.250	950	1.050	1.050	850	350	4.250
Industry	-	-	-	-	-	-	125	5.284	5.730	6.562	7.512	25.213	125	5.284	5.730	6.562	7.512	25.213
Geological and Mining Research	-	-	-	-	-	-	-	600	600	400	400	2.000	-	600	600	400	400	2.000
Tourism	500	-	924	-	-	1.424	3.050	6.310	5.736	4.941	5.539	25.576	3.550	6.310	6.660	4.141	5.539	27.000
TOTAL (II)	3.321	3.072	4.020	2.791	2.750	15.954	6.769	19.769	19.650	19.044	22.567	87.799	10.090	22.841	23.670	21.835	25.317	103.753
TOTAL (I) + (II)	187.295	156.667	133.141	62.082	45.753	584.938	24.425	82.018	98.667	170.507	193.224	568.841	211.720	238.685	231.808	232.589	238.977	1,153.779

1. State Contribution to the "Centre de Securite de l'Aviation Civile".

2. They are in £L:

a.	Studies on urban re-organisation	2,300,000
b.	Equipment for chief towns	9,920,000
c.	Sewage systems	10,864,000
d.	Prisons in Tripoli, Saida, Zahle	3,600,000
e.	Unforseeable	1,560,000
		28,244,000

3. Provisional figures.

Advances already approved for 'other agencies	10.000
Unforseeable advances	26.000
Miscellaneous expenditure not allocated yet	17.221
GENERAL TOTAL	1,207.000

Source: Ministry of Planning, Beirut.

TABLE XXI

DEVELOPMENT PLAN PROJECT (1964-1968)

PLAN OF PUBLIC EXPENDITURE INCLUDING TREASURY ADVANCES IN VERTICAL PERCENTAGES.

	APPROVED PROJECTS						NEW PROJECTS						TOTAL						
	1964	1965	1966	1967	1968	TOTAL (A)	1964	1965	1966	1967	1968	TOTAL (B)	1964	1965	1966	1967	1968	TOTAL (A)+(B)	(1)
I. INFRASTRUCTURAL EXPENDITURE																			
a) Economic Infrastructure																			
Roads	17.8	19.3	24.5	38.8	28.3	22.8	-	10.8	8.9	10.6	15.3	11.5	15.8	16.3	17.9	18.1	17.8	17.2	16.4
Drinking Water Ducts	12.1	15.8	14.0	2.0	-	11.5	-	0.2	0.2	6.0	5.2	3.6	10.7	10.5	8.1	4.9	4.2	7.6	7.3
Irrigation	7.0	9.7	11.4	2.6	2.3	7.9	4.5	12.7	12.6	13.8	12.6	12.6	6.7	10.7	11.9	10.8	10.7	10.2	9.8
Electricity	25.0	13.5	18.0	19.3	24.0	19.7	-	7.8	6.6	11.8	9.1	8.9	22.1	11.6	13.1	13.8	11.9	14.3	13.7
Municipal	-	-	-	-	-	-	2.6	0.9	0.8	0.5	0.5	0.7	0.3	0.3	0.4	0.4	0.4	0.4	0.3
Communications	12.7	12.2	0.9	1.9	-	7.8	8.2	2.4	3.0	5.3	4.7	4.4	12.2	8.9	1.8	4.4	3.8	6.1	5.8
Buildings	15.4	10.6	5.6	1.9	-	9.2	-	-	-	4.1	4.1	2.7	13.6	7.0	3.2	3.5	3.3	6.0	5.7
Miscellaneous equipment	4.2	6.2	8.0	-	-	4.8	-	-	-	-	-	-	3.7	4.0	4.6	-	-	2.5	2.4
Total (a)	94.2	87.3	82.4	66.5	54.6	83.7	15.3	34.8	32.1	52.1	51.5	44.4	85.1	69.3	61.0	55.9	52.1	64.3	61.4
b) Social Infrastructure																			
Health	-	-	-	-	-	-	11.6	9.6	10.7	7.9	9.1	9.2	1.3	3.3	4.5	5.8	7.3	4.5	4.4
Education	2.0	0.8	-	-	-	0.8	26.9	23.2	28.3	22.8	21.5	23.6	4.9	6.5	12.1	16.7	17.5	12.1	11.5
Antiquities	1.1	1.3	1.5	-	-	1.0	5.6	1.9	1.6	1.8	1.7	1.9	1.6	1.5	1.5	1.3	1.4	1.5	1.4
Social Security	0.4	7.7	12.0	25.8	35.0	10.4	-	-	-	-	-	-	0.3	5.0	6.9	6.9	6.7	5.2	5.0
Technical training	-	-	-	-	-	-	0.2	0.3	0.3	0.1	0.2	0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.1
O.D.S.	-	-	-	-	-	-	12.7	6.1	7.1	4.1	4.3	5.4	1.5	2.1	3.0	3.0	3.5	2.6	2.5
C.N.R.S.	0.5	0.9	1.1	3.2	4.4	1.4	-	-	-	-	-	-	0.5	0.6	0.7	0.9	0.8	0.7	0.7
Total (b)	4.0	10.7	14.6	29.0	39.4	13.6	57.0	41.1	48.0	36.7	36.8	40.2	10.1	21.1	28.8	34.7	37.3	26.7	25.6
TOTAL (I) = (a + b)	98.2	98.0	97.0	95.5	94.0	97.3	72.3	75.9	80.1	88.8	88.3	84.6	95.2	90.4	89.8	90.6	89.4	91.0	87.0
II. DIRECTLY PRODUCTIVE ACTIVITIES																			
Agriculture	1.5	2.0	2.3	4.5	6.0	2.5	10.8	8.0	6.6	3.7	4.5	5.4	2.6	4.0	4.1	3.9	4.8	3.9	3.8
Fisheries	-	-	-	-	-	-	3.9	1.3	1.1	0.5	0.2	0.7	0.4	0.4	0.4	0.4	0.2	0.4	0.3
Industry	-	-	-	-	-	-	0.5	6.4	5.8	3.9	3.9	4.4	0.1	2.2	2.5	2.8	3.1	2.2	2.1
Geological and Mining Research	-	-	-	-	-	-	-	0.7	0.6	0.2	0.2	0.4	-	0.3	0.3	0.2	0.2	0.2	0.2
Tourism	0.3	-	0.7	-	-	0.2	12.5	7.7	5.8	2.9	2.9	4.5	1.7	2.7	2.9	2.1	2.3	2.3	2.2
TOTAL (II)	1.8	2.0	3.0	4.5	6.0	2.7	27.7	24.1	19.9	11.2	11.7	15.4	4.8	9.6	10.2	9.4	10.6	9.0	8.6
TOTAL (I) + (II)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

(1) % on the basis of the general total of £L 1,207,000,000 in Table XX

Advances already approved for 'other agencies'	0.8
Unforseeable advances	2.2
Miscellaneous expenditure not allocated yet	1.4
GENERAL TOTAL	100.0

Source: Ministry of Planning, Beirut.

T A B L E XXII

DEVELOPMENT BUDGET: FINANCE MINISTRY'S ESTIMATES OF APPROVED PROJECTS

In £L Millions

Item	1964	1965	1966	1967	1968	Total
Expenditure on equipment for administration and certain expenditure on large projects	63.9	70.5	86.5	95.0	114.4	430.3
Project of £L 62 m. Water	6.2	1.0	-	-	-	7.2
Project of £L 84 m. Roads	12.5	12.5	12.5	12.5	7.0	57.0
Project of £L 450 m. of which: Irrigation 64 m. Drinking Water: 76 m. Electricity: 72 m. Roads: 124 m. Water ducts: 9 m. Antiquities: 10 m. Buildings: 20 m. Rebuilding fund: 75 m.	46.0	30.5	31.5	12.0	8.0	128.0
Fair of Tripoli	8.0	4.0	-	-	-	12.0
Green Plan	0.5	1.0	1.5	2.0	2.2	7.2
Modern Prisons	6.6	3.5	-	-	-	10.1
Cadastral Survey	2.7	2.1	2.1	2.4	2.1	11.4
Min. of Defence Bdgs.	2.0	3.0	2.3	-	-	7.3
Min. of Information	0.2	0.2	0.2	0.2	0.2	1.0
Refrigerated Wagons	-	-	-	-	-	-
T O T A L	148.6	128.3	136.6	124.1	133.9	671.5

Source: Planning Commission Report to Ministry of Finance, 1964-65. Unpublished. G. Corm, Politique Economique et Planification au Liban 1953-63 Beyrouth, Imprimerie Universelle, 1964.

expenditure, which reflects the new attitude towards the social problem in Lebanon. Roads and electricity still absorb the largest percentages of the total, 16.4% and 13.7% respectively (last column of Table XXI) but education comes third with 11.5% as against 0.8% in the approved projects plan.

Thus adopting the Finance Ministry's estimate for the cost of approved projects - £L 868.05 million - total State expenditure for the five year plan is expected to reach £L 3,493.3 million on the Finance Ministry's estimate of 9.5% annual increase in the ordinary budget, or £L 3,333.7 million on the Planning Commission's estimate of 6%.

B. State Receipts

The question that arises now is whether the State will be able to finance the five year plan from tax receipts alone. The Planning Commission considered the various alternatives open and finally came out against any major increase or reform in the tax system. Instead it recommended a change in the methods of tax collection and a more efficient collection. Having adopted this alternative it then projected tax receipts over the period covered by the plan taking into consideration a slight decrease in customs revenues following an expansion in industrial production,[1] the exemption

1. This does not seem entirely justifiable because the increase in income which industrial expansion might bring about would increase imports.

from customs duties of raw materials going into industry, and a normal increase in oil revenues. The estimates are shown in Table XXIII. The total expected return amounts of £L 2,670.2 million. This figure now has to be compared with the expenditure estimates.

A 9.5% annual increase in the ordinary budget would produce a total State expenditure of £L 3,493.3 million and therefore a budget deficit of £L 823.1 million over the five year period. A 6% increase in the ordinary budget would make State expenditure amount to £L 3,333.7 million and would therefore produce a deficit of £L 663.5 million over the five year period.

4. The Services Sector

Earlier it was pointed out that Lebanon relied for a large part of its revenue on this sector and that with the changing conditions in the Middle East this sector has kept up its importance by being highly adaptable. Today banking and finance are very lucrative activities because capitalists of the Middle East have been depositing their funds in Beirut, which Lebanese bankers have been able to invest at home and abroad. But these same capitalists are gradually becoming more sophisticated in their investment decisions and now tend to by-pass Beirut by investing in the developed capital markets of Europe and America. On the other hand they are encour-

TABLE XXIII

EXPECTED STATE RECEIPTS ON BASIS OF PLANNING COMMISSION'S RECOMMENDATIONS, 1964 - 1968

	1964		1965		1966		1967		1968		TOTAL	
	In £L Millions	In %	In £L Millions	In %	In £L Millions	In %	In £L Millions	In %	In £L Millions	In %	In £L Millions	In %
I. DIRECT TAXES AND STAMP AND REGISTRATION DUTIES												
A. Direct Taxation												
1. Tax on built-up properties	26.5	6.3	35.0	7.4	40.0	7.8	45.0	8.2	50.0	8.4	196.5	7.7
2. Income Tax	46.0	11.0	60.0	12.8	70.0	13.8	77.0	14.0	85.0	14.3	338.0	13.3
3. Registration of private cars	8.8	2.1	9.0	1.9	9.7	1.9	10.5	1.9	11.2	1.8	48.9	1.9
4. Transfer duties	2.5	0.6	2.5	0.5	3.0	0.6	3.0	0.5	3.5	0.6	14.6	0.6
5. Other duties	0.1	0.0	0.2	0.1	0.2	0.1	0.2	0.1	0.2	0.1	0.9	0.1
TOTAL (A)	83.6	20.0	106.7	22.7	122.9	24.2	135.7	24.7	149.9	25.2	598.8	23.6
B. Stamp and Registration Duties												
1. Stamps	15.0	3.6	16.5	3.5	17.0	3.4	18.7	3.4	21.0	3.5	88.2	3.5
2. Registration Duties	16.5	3.9	18.0	3.8	20.0	3.9	22.0	4.0	24.0	4.0	100.5	4.0
3. Road Tax	3.0	0.7	3.5	0.8	3.5	0.7	4.0	0.7	4.0	0.7	18.0	0.7
4. Other duties	6.1	1.5	6.7	1.4	7.3	1.4	8.0	1.4	8.4	1.4	36.5	1.4
TOTAL (B)	40.6	9.7	44.7	9.5	47.8	9.4	52.7	9.5	57.4	9.6	243.2	9.6
TOTAL (I) = (A + B)	124.2	29.7	151.4	32.2	170.7	33.6	188.4	34.2	207.3	34.8	842.0	33.2
II. INDIRECT TAXES												
1. Customs Duties	137.5	32.9	144.3	30.7	151.5	29.8	159.0	28.9	167.0	28.1	759.3	29.9
2. Fuel Tax	46.0	11.0	49.2	10.5	52.6	10.4	56.2	10.2	60.1	10.1	264.1	10.4
3. Tax on Tobacco	33.0	7.9	40.0	8.5	41.0	8.1	45.0	8.2	49.0	8.2	208.0	8.2
4. Tax on Cement	4.0	1.0	5.5	1.2	5.5	1.1	6.0	1.1	6.5	1.1	27.5	1.1
5. Other taxes.	5.6	1.3	5.0	1.1	5.7	1.1	6.3	1.1	7.0	1.2	29.6	1.1
TOTAL (II)	226.1	54.1	244.0	52.0	256.3	50.5	272.5	49.5	289.6	48.7	1,288.5	50.7
III. RECEIPTS FROM STATE PROPERTIES	11.5	2.8	12.0	2.6	13.0	2.6	13.5	2.5	14.0	2.4	64.0	2.5
TOTAL (III)	11.5	2.8	12.0	2.6	13.0	2.6	13.5	2.5	14.0	2.4	64.0	2.5
IV. MISCELLANEOUS RECEIPTS												
1. Oil Revenues	24.0	5.7	26.4	5.6	29.0	5.7	31.0	5.6	34.0	5.7	144.4	5.7
2. Other receipts	32.2	7.7	35.6	7.6	38.5	7.6	45.0	8.2	50.0	8.4	201.3	7.9
TOTAL (IV)	56.2	13.4	62.0	13.2	67.5	13.3	76.0	13.8	84.0	14.1	345.7	13.6
TOTAL OF BUDGET RECEIPTS (I + II + III + IV)	418.0	100.0	469.4	100.0	507.5	100.0	550.4	100.0	594.9	100.0	2,540.2	100.0
V. FISCAL CHANGES												
1. Supplementary tax on income	-		3.5		4.5		6.0		7.6		21.6	
2. Supplementary registration tax	1.5		3.0		4.3		5.5		6.8		21.1	
3. Supplementary stamp duty	3.5		8.0		13.5		18.8		23.5		67.3	
4. Supplementary tax on cement	2.0		3.0		4.0		5.0		6.0		20.0	
TOTAL (V)	7.0		17.5		26.3		35.3		43.9		130.0	
TOTAL (I + II + III + IV + V)	425.0		486.9		533.8		585.7		638.8		2,670.2	

Source: Ministry of Planning, Beirut

aged to do so by the foreign bankers who go straight to them to encourage them to invest in their respective countries. These capitalists do not now find in Lebanon the investment opportunities they seek because the capital market is underdeveloped, and thus capital which would previously have come to Beirut is now going straight abroad.[1] If banking is to retain its importance in Lebanon a capital market with suitable investment opportunities should be created in Beirut, to attract the funds which at the moment tend to go to the financial centres of Europe and America. Not only would this help the banking sector but it would also yield great amounts in invisibles which would help the balance of payments.

In this chapter the problems that Lebanon might have to face in the future were considered and the various official plans for the development of the country and credit requirements that would ensue were described. How they could be met and the implications for a Central Bank are the subjects of the next chapter.

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1. It seems that even in the field of deposits, Beirut is losing the previous natural appeal it had for Middle Eastern capitalists, as banks in Beirut have had to increase their foreign currency deposit rates by $\frac{1}{2}$ to 1% to compete with the recently increased rates in New York, London and other financial centres. See L'Orient, 23rd April, 1966.

CHAPTER IV

FINANCING THE ECONOMIC DEVELOPMENT OF LEBANON

This chapter starts by considering whether the commercial banking sector in Lebanon can provide the type of credits required for the economic development of the country as outlined in the preceding chapter. Then how it can provide these credits is analysed and finally the role and responsibilities of a Central Bank are considered.

I. The Potentialities of the Lebanese Banking Sector

As noted earlier[1] the ratio of cash to deposits kept by banks in Lebanon is low and unstable when compared to that of other countries - for example it was 4.5% in April 1964 and 2.5% in September of that same year - and the liquidity ratio is high - 42.1% in April 1964 and 43.2% in September. It was also noted that most of the liquid assets of the banks are held abroad: their foreign investments amounted to £L 1,005.8 million in April 1964 and £L 1,270.5 million in September of that same year.

Since it ~~is~~ was the practice of commercial banks in Beirut to maintain foreign assets roughly equal to foreign liabilities, the total foreign liabilities of the Banks for April and September 1964 - i.e., liabilities

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1. See Chapter II p.97

to banks and non-banks in foreign currencies - were roughly equal to the two figures just given. Part of these liabilities are owed to private individuals - Lebanese and foreigners - who are able to deposit their money in the banks in any currency they choose; as most of the deposits are in fact savings depositors can be influenced to some extent on the choice of currency. On the whole banks prefer that people choose foreign currencies rather than Lebanese Pounds, and in fact higher rates are paid on foreign currency deposits.[1] This is explained by considering the six graphs below. These show the relationship at equilibrium between the various rates of interest and rates of return in the money market, and the conditions under which the banks would pay higher interest rates on deposits in foreign currencies than on those in local currency. We start by assuming that banks incur no costs and make no profits so that the rates of return can be made equal to the corresponding deposit rates. We assume this for simplicity's sake as it will make the graphs easier to construct.[2]

Figure 1 shows the relationship that exists between the supply of the foreign securities that banks look for and the demand for such

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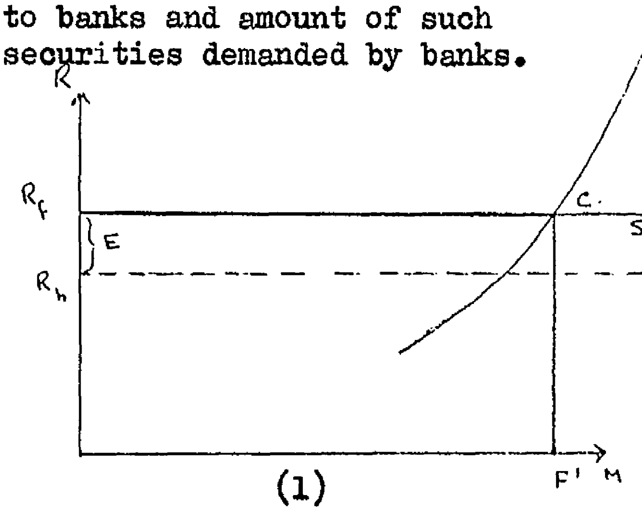
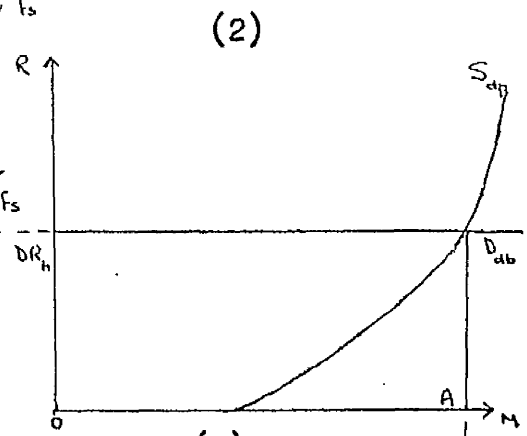
1. Information obtained from private interviews with several bankers in Beirut.

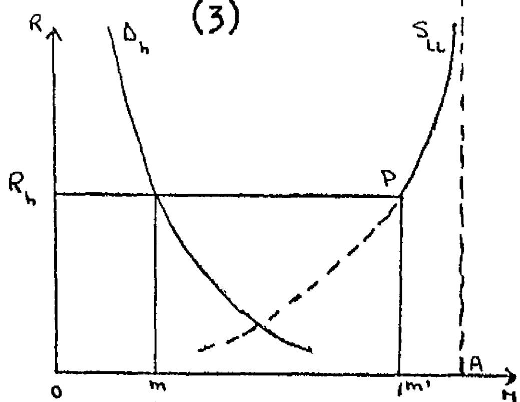
2. Alternatively we could change the scales so that for example a rate of return R_h corresponds to a maximum deposit rate of DR_h but then we would have to assume constant costs and profit margins.

Supply of foreign securities to banks and amount of such securities demanded by banks.

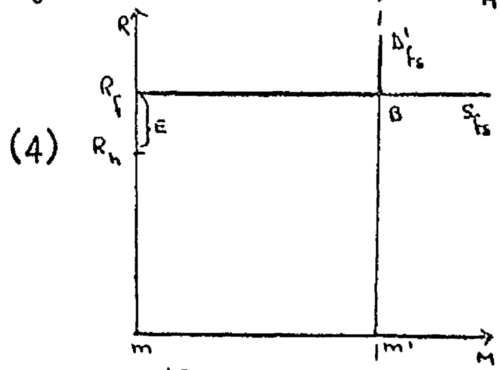




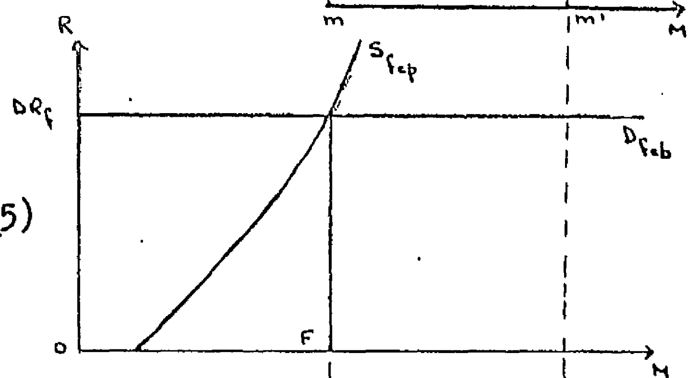
Supply of deposits to banks and the demand for funds by banks in £L.



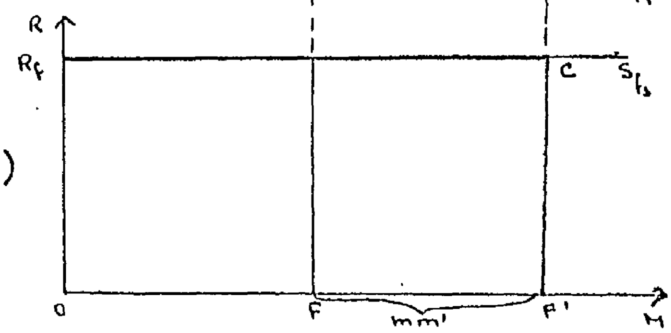
Domestic market: supply of £L by banks and demand for £L.



Deficiency of demand for £L., mm', converted into foreign currency. Expected return R_h + E.



Supply of foreign currencies by the public and demand for foreign currencies by banks. (5)



Total amount of funds available for the purchase of foreign securities. (6)

securities by the banks. The Y axis represents the various rates of return, and the X axis the amounts of funds available for foreign investment. The supply curve R_fS_{fs} is perfectly elastic at the rate of return R_f[1] which the banks expect to get because the world supply of such securities is presumably much larger than the demand for them by Lebanese banks. R_fC is the amount of such securities demanded by banks. This amount is determined by the relationships described in figures 4 and 5. The curve D_{fs} is the locus of C for different values of R_f given that the shapes of the curves in the figures following are unchanged. It is one of a family of curves.

In private interviews, bankers said that their practice ~~is~~ was to keep their foreign assets roughly equal to their foreign liabilities, but they said also that if people cannot be persuaded to deposit in foreign currencies, they consider the possibility of converting some of their funds acquired in Lebanese Pounds into foreign currencies so as to invest them abroad, and the fact is that some bankers are increasingly tending to do so. The reason is that there is a shortage of demand at the rate of return banks are prepared to accept in Lebanon. But in spite of the shortage of demand for loanable funds by the public, banks still compete for deposits. This leads us to think that the rate of return on foreign securities might be ~~is~~ higher than the local rate of return, at certain times, because when they convert their holdings of Lebanese Pounds into foreign

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1. R_f may be above, below or equal to R_h. For illustrative purposes it is assumed in this section that R_f is above R_h.

currencies, banks run exchange risks which make them expect a higher rate of return abroad. As the supply of the type of foreign securities they require is completely elastic at the expected rate R_f, whatever they cannot invest in Lebanon at an acceptable rate of return, can be invested abroad. If the total exchange risk incurred by converting Lebanese Pounds into foreign currencies is denoted by E,[1] the foreign rate of return R_f sets a minimum acceptable rate of return R_h in the domestic market that is equal to R_f minus E. In other words there is no supply of loanable funds in the Lebanese market at rates of return below R_h.

As it was assumed that banks incur no costs and make no profits R_h sets a maximum equal value DR_h to the rate of interest that banks are prepared to pay on deposits in local currency. This is shown in figure 2 where rates of interest appear on the Y axis and amounts of funds on the X axis. It is reasonable to assume that owing to the very stiff competition that no doubt exists in the Lebanese banking sector the maximum rate of interest DR_h is paid on deposits. At DR_h the banks' demand for deposits is completely elastic as what they cannot invest in Lebanon can always be invested abroad at R_f. The demand curve for deposits is therefore the flat DR_hD_{db}. The supply of deposits by the public S_{dp} is an increasing function of the rate of interest. The curve does not start at the origin as even if no interest were paid on deposits

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1. Which is here assumed to be positive, although it could be negative or zero depending on whether the exchange rate of the Lebanese Pound is expected to appreciate, depreciate or remain stable.

people would still find it convenient to deposit a certain amount of funds in the banks for transactions purposes. At the start the curve is quite elastic because in Lebanon banks do not have to compete with alternative liquid investments to acquire funds, because such investments do not exist. But soon, whatever can be deposited with banks is deposited and the supply of deposits curve becomes rather inelastic as banks gradually have to acquire funds which would normally have gone into more illiquid investments. The intersection point of DR_hD_{db} with S_{dp} determines the total amount of funds in Lebanese Pounds that are available in the banking sector. This amount is OA.

The amount OA determines in figure 3 the supply of loanable funds in Lebanese Pounds to the local market. Here rates of return are plotted on the Y axis. The supply of such loanable funds by the banks is an increasing function of the rate of return but there is no supply at a rate lower than R_h determined in figure 1 by the foreign rate R_f and the exchange risks element E. Thus the supply of loanable funds curve is R_hPS_{LL}. The curve is asymptotic to the perpendicular from A as OA is the total amount of funds available, and gradually banks have to be paid more and more interest to forego some of their liquid funds. The demand for such loanable funds by the public D_h, is a decreasing function of the interest rate. Now, at the minimum rate of return R_h Om funds are demanded while Om' are offered. The shortage of demand for

Lebanese Pounds at R_h referred to earlier, is here shown by the existence of the excess supply mm'. As these funds can be invested abroad at an acceptable rate that takes into account the exchange risks involved in converting Lebanese currency into foreign currencies, they create a demand for foreign securities pictured in figure 4. Here the rates of return are again plotted on the Y axis. As in figure 1 R_fS_{fs} is the supply curve of foreign securities at the rate R_f, and is completely elastic. The demand curve is $R_fBD'_{fs}$. The portion of the curve R_fB is perfectly elastic as banks invest at R_f all the amount mm' that is not demanded in Lebanon. At B, however, the curve becomes completely inelastic as mm' which determines the length R_fB is essentially a residual of what is not demanded in the local market. Banks will try to satisfy the home demand first at the rate R_h so as not to encourage new banks to get into the market and make deposits even harder to acquire. Although in figure 4 R_f is the rate of return that banks obtain on their investments, it is equivalent to the lower rate R_h which they could obtain locally had there been a demand for such funds, as R_f needs to be discounted for the exchange risks element E.

Now figure 5 shows the relationship that exists between the supply of foreign currency deposits to banks, S_{fcp} and the demand for such deposits by the banks, DR_fD_{fcb}. The former is an increasing function of the rate of interest, and the curve does not start at the origin as people may wish to keep certain funds in foreign currencies for foreign trade purposes even if no interest were paid on such deposits. The rate of return on foreign securities R_f sets a maximum limit to the rate of return that banks are willing to pay on deposits in foreign currencies. As we assume that banks incur no costs and make no profits, here again we can think that the very stiff competition that exists in the banking sector has pushed the deposit rate to the maximum limit of DR_f equal to R_f. At the rate DR_f the demand for foreign currency deposits by the banks is infinitely elastic: however much they can get, they can invest abroad at a rate of return R_f. The point of intersection of the two curves determines the amount OF available to banks in foreign currencies and which they can invest abroad without incurring exchange risks.

This leads us to figure 6 which is similar to figure 1. At R_f the supply of foreign securities S_{fs} is completely elastic. The amount of foreign securities demanded by the banks is R_fC. The length of R_fC is determined by the amount of OF' available for foreign investment and which amount is composed of OF available originally in foreign currencies (fig. 5), and of FF' equal to mm', being the residual of Lebanese currency not demanded in the local market at R_h and converted into foreign currencies for investment abroad (fig. 3 and 4).

Although the rate of return on all the foreign investment is R_f, the amount OF bears no exchange risks while the amount FF' - equal to mm' - incurs the exchange risks denoted earlier by E. It is now evident why banks try to influence depositors in their choice of currency, for the larger the amount OF in the total OF', the less exchange risk they incur. Therefore they are willing to pay a higher rate of interest on deposits in foreign currencies - which they are able to because the foreign rate is higher than the local rate - and let the depositors bear the exchange risks. From this model it should also be clear how a movement in the rate of return abroad can influence interest rates in Lebanon.

Now if we go back to figure 3, it is clear that the local demand for short-term funds can be increased to Om' without affecting the supply conditions. As a matter of fact if the curve D_h is shifted to the right, which an increased demand at R_h would imply, as it gets closer to m', banks might then be disinclined to pay more interest on foreign currency deposits; this might induce people to deposit in Lebanese Pounds instead in order to avoid exchange risks. Were this to happen S_{dp} in figure 2 would shift to the right increasing the amount OA and thus Om' in figure 3 available in the domestic market. If D_h is shifted to the right the amount mm' becomes smaller and this in turn affects the demand for foreign securities by the banks. The amount now demanded decreases and R_fC in figures 1 and 6 become smaller while D_{fs} moves to the left. As long as D_h (figure 3) intersects R_hPS_{LL} at a point between R_h and P no change in supply conditions should occur as banks would repatriate funds invested abroad. Only if the point of intersection is beyond P would the equilibrium of interest rates be upset. Therefore unlike mose underdeveloped countries of the world Lebanon does not suffer from a scarcity of finance. In other words an increase in demand for funds at home could easily be met by the banking sector by diverting investment from abroad.[1]

But it may be asked whether it is not idle to consider shifting D_h to the right and asking the banks to divert some of their investments from abroad when there seems to be a deficiency of demand at home at the minimum rate of return R_h as shown in figure 3. In fact, it is not, because figure 3 shows the supply and demand for funds in the money market, i.e., for short-term loans only. Therefore, the deficiency is in the demand for short-term money, and it is the consideration of the supply and demand conditions for medium- and long-term loans that makes it necessary to see whether nothing could be done to use the vast resources of the money market to satisfy the demand for these loans. In effect as explained in Chapter III at the longer end of the market there are no adequate credit facilities, and a growing demand from both private and public sectors. It may seem strange that institutions

1. The problem of inflation is dealt with at a later stage.

did not appear at an earlier date to meet the growing demand. Why they did not, can be attributed to several factors, the most important of which being the traditional feeling that banks should not tie up in illiquid medium- and long-term advances funds which they have acquired on sight or at short notice; and moreover, they could always invest profitably and safely abroad. Besides, the demand for such credits is relatively recent,[1] and it was generally known that the Government had plans for a Development Bank: this could have discouraged people from creating such institutions before knowing what that bank was going to do. Finally uncertainty about what the new Central Bank would be like could have created an attitude of wait-and-see and therefore delayed any such plans.

Conservative banking practice would in fact exclude at all times the possibility of using the banks' resources in medium-term credits or bonds, and would confine them instead to very short-term bills and self-liquidating paper. It would also require banks not to lend against the security of real estate which they have been doing in Lebanon. This is no more than the orthodox financial policy summarised in one of the Annual Reports of the Bank of International Settlements which says:

> "Even when the credits granted by banks may be said to have had their counterpart in genuine savingsm there is still the very real risk that the banks may become more and more involved in the long-term financing of industry, with the result that their balance sheets will mount very rapidly - as has recently

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1. See Chapter III

> been the case in Germany. If business continues to prosper, all may be well, but should there be a turn in the trend, losses are more liable to be suffered in the case of long-term investments; if the depositors think they have reason to fear for the amounts entrusted by them to the banks and therefore become nervous, the ground is prepared for a financial crisis, which may be difficult to overcome."[1]

The problem now is whether there is a case for the banks to deviate from orthodox financial policies in the Lebanon, i.e., to use money acquired mostly on short-term, to grant long- or medium-term credit or to buy long-term bonds or whether they are justified in granting credits against the security of real estate. It will be recalled[2] that banks are very liquid not only because a large part of their deposits are time and savings account, but also because demand deposits show a very low turnover. In the year ending in April 1964, for example, demand deposits were used only once every two and a half months. We came to the conclusion then that a very large part of demand deposits can be looked at as a disguised form of time deposits or even investment in shares and bonds. Therefore, demand deposits are not used in what has been called the 'traditional' way - i.e. the way that prevails in more advanced countries - and there is then no reason why orthodox financial policies should apply in their extreme and strictest form. This point is supported by the Chief General Manager of the Union Bank of Switzerland when he describes the nature of deposits in Continental Europe:

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1. Banks of International Settlements, 23 Annual Report, 1953, p. 73

2. See Chapter II, pp. 98-101

"A further belief is that bank deposits and credit extended must in no way completely coincide with regard to time. Whereas, for example, in the countries of Continental Europe the public prefer to place its savings in banks, in the Anglo-Saxon countries, it would rather make use of the share and bond market for the purpose of savings. Because in both cases no significant difference exists in the character of the invested money, it would appear appropriate for the European commercial banks to lend part of their deposits on an intermediate or long-term basis."[1]

Since by far the largest part of deposits in Lebanon are left unused in the banks for long periods and therefore are no more than savings, part of them can be used to meet the unsatisfied demand for medium- and long-term loans. Therefore banks are able to assist the private and public sectors in the economic development of the country by providing them with the types of credit which they require. If that were done, the foreign securities requirements R_fC in figure 1 would decrease and D_{fs} would then shift to the left as demand for medium- and long-term

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1. Dr. A. Schaeffer, 'Commercial Banking in the Financing of Industrial Investments.' Lecture given at the 16th International Banking Summer School at Semmering Austria, in 1963, published with other lectures read in Commercial Banks in Relation to Medium- and Long-Term Credits, Bruden Rossenbraum, Vienna, p. 200.

   In February, 1958, Mr. Zolotas, Governor of the Bank of Greece went as far as to suggest that in under-developed countries banks should not merely wait for businessmen to demand funds but should "effectively suggest and recommend the establishment, modernization or merger of business and even, if need be, participate indirectly in productive enterprises". Reported by A.R. Low, 'The Varied Role of Central Banks', Economic Record, December 1958, p. 321, who expresses the same view: "(in under-developed countries) the idea which is widely held in more developed countries - that commercial banks should not provide long-term finance for fixed capital purposes - is much less appropriate".

credits in Lebanon gets satisfied. The deficiency of demand for short-term loans mm' (figure 3) would then help to provide finance in the capital market in Lebanon.

The same argument can be used to justify the practice of Lebanese banks with regard to lending against the security of real estate. Besides the banks had to do it as real estate was the chief asset that people could offer.

However demand deposits may be left unused in the banks, but they are still withdrawable without notice. Savings deposits are withdrawable on demand too, while time deposits, although technically withdrawable only after a notice can in practice be withdrawn on demand, the interest for the period of notice being automatically deducted. Therefore any nervousness of depositors could cause a financial crisis if banks have invested their deposits in medium- and long-term paper which they cannot liquefy easily. The wisdom of permitting such a risk can be questioned, but in a period of recession or when depositors become nervous, the danger of illiquidity involves not only long-term but also short-term credit if there are no proper rediscounting facilities, and therefore what is needed is the provision of adequate rediscounting facilities for long-term paper, if long-term credits are to be made. As the only final source of cash is the Central Bank, it is this latter that will have to provide these facilities.

"There is a presumption, a strong presumption, against long-term lending by banks. Traditionally this has been argued from the fact that most of a banker's liabilities are payable on demand or at short notice, and that, therefore, his assets must be correspondingly short-term. Put in this extreme form, the argument is fallacious: the banker is able to make a living because he knows that repayment of his deposits is in fact not required in total at any one time, and he could not make any living by matching his assets precisely to his liabilities. On the other hand, he cannot behave like an investment trust. The liquidity he has to maintain is a matter of degree . . . The upshot is that the Central Bank, though especially cautious in its own business with the general public, should adopt no rigid rule against medium-term and long-term lending by commercial banks. Even the smallest banks must lend for longer terms than would match their assets and the Central Bank must be prepared to supply liquidity in case of emergency."[1]

A banker does not make plans as though an emergency was always round the corner. His plans are based on the normal behaviour of people, but safeguards are taken should people deviate from their normal behaviour. The old concept of banks having to hedge against a sudden and heavy withdrawal of deposits is now outdated in most developed banking systems, partly because of the central bank backing which they enjoy, and partly because the risk of such a massive withdrawal has generally receded as deposits are looked upon as a highly convenient and increasingly safe method of payment. Therefore, the danger in allowing the banks to provide long-term credit is not really in the illiquidity of such investments as in the consequences that would follow from rediscounting medium- or long-term paper.

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1. Sayers R.S. Central Banking in Underdeveloped Countries, National Bank of Egypt, 50th Anniversary Commemoration Lectures - Cairo 1956. My italics.

The first such new danger is the risk involved in lending over such a long period. As the credit is granted over a number of years the risk element is correspondingly bigger because of the difficulties involved in forecasting the outcome of such an investment so far ahead.

Another such new danger, but now involving the whole economy, is inflation. Once the rediscounting idea has been adopted one can easily see how inflation can come about. Banks grant a - say - five year credit, and rediscount the paper signed by the debtor at the central bank. If the banks then expand advances on the basis of their new reserves there is an additional injection of cash into the economy which might be used for advances which the normal bank multiplier working as a result of the first advance would not have made possible. This will increase the inflationary danger unless there is a greater leakage in the multiplier. As the rediscounted paper has a five year life, the cash injected into the economy is not likely to be withdrawn from circulation before five years - unless the borrower decides upon an early repayment. However, in ordinary circumstances, rediscounting of long-term paper should not be heavy because of the nature of the banks' deposits. These are not only a convenient means of payment but also a store of value, for whether on term or on sight, they are to a large extent left unused in the banks and have much the same characteristics as funds that would normally have been invested in shares and bonds.

The facilities provided would be more an insurance for an eventuality than a source of permanent finance. Thus banks would be using savings in their lending activities and no inflationary consequences of a monetary nature should occur as long as this is the case. But if the paper is used as a means of expanding reserves and to make further loans new circumstances would emerge and safeguards could be taken against such occurrences. Moreover, the danger of inflation is not confined to medium- and long-term credit only, but to all types of credit. As the French Lorrain Committee reported:

> "A credit operation does not become inflationary simply because the life is longer than what is commonly called short-term; the risk of inflation cannot in effect be assessed as a function of the lives of the credits, but rather as a function of their nature and their healthy character. The danger of inflation starts appearing when the volume of the means of payment exceeds the value of the goods and services available in the economy, or likely to be produced by it in the immediate future. All types of bank credit can be the origin of such an excess of demand."[1]

On the other hand banks have invested abroad a large part of their funds. Such foreign investment is deflationary in terms of demand on resources. Now if they divert some of their foreign investment to Lebanon, which they would have to if they are to grant long-term credits, the increased activity might exert pressure on some employed resources. Any such development activity will be inflationary, and hence finance

1. Comité chargé d'étudier le financement des investissements, Rapport May 1963. Appeared in the Supplement to Statistiques et Etudes Financières, November 1963, Ministère des Finances, Paris. (Translation is mine).

from bank credit for this should not be permitted to have any secondary monetary effect. Now there are certain conditions everywhere for rediscounting short-term paper. Other conditions could equally well be set for the rediscounting of medium- and long-term paper to prevent abuse and to ensure that these credits are granted carefully and in an orderly way.

How the banks could provide those credits and what safeguards could be adopted to prevent abuse will be discussed in the following sections. But before moving into that, the implications of such a new attitude to the operations by the banks should perhaps be considered. Bank lending in Lebanon will undergo some transformation if banks are to start providing medium- and long-term credits in one way or another, because then their operations will no longer be concentrated on the short end of the market. Moreover, a new feature for the Lebanon is that banks will also be financing the public sector. The extent to which this will be done depends on the pace at which public expenditure will grow and the development plan outlined in Chapter III will be implemented; but there is no doubt that this part of the banks' business can be substantial. This change in banking practice is not peculiar to the Lebanon. It is in fact a stage in the evolution of the banking mechanism with relation to economic development as was indeed pointed out at the Sixth International Banking Summer School:

"Bank credit has lost to a great extent its self-liquidating and self-securing character. It is now being called on to play an extremely important part in the financing of the expenditure of the State and of the public authorities, while its relative importance for the financing of the private sector has diminished ... The prime mover in the evolution of credit has been the general economic change of our time. In this the most important factor has been the enormous growth in State spending and the penetration of State intervention into every sector of economic life. A second reason lies in the fact that the services required of the banks by the various sectors of the economy have undergone changes and a demand has arisen for altogether new services. Finally, the banks, seeing only a reduced possibility of employing their resources profitably in their traditional fields of activity, have been led to extend their operations into new territory."[1]

The difference in the case of Lebanon, however is that banks started looking for 'operations into new territory' before they could be provided to their satisfaction[2] in the country itself and so looked abroad and found them abroad. So the point to remember is that if such operations are going to be made possible in the Lebanon, they would have to be made competitive with the opportunities abroad.

Finally, if banks are going to lend on medium- and long-term and be able to rediscount such paper it will then be possible to combine the demand curves for short-term and long-term credits together and the new curve could then be represented by D_h in figure 3.

1. Dr. S. Schweitzer, 'The Transformation of Bank Credit and its New Forms'. Lecture given at the 6th International Banking Summer School in 1953 which appeared with other speeches in Recent Evolution of the Role of the Banks in the Economy, Association Belge de Banques, Brussels, pp. 75-98. Extracts are on pages 79, 80.

2. Demand for funds is not enough: a guarantee of liquidity or marketability is necessary to satisfy banks.

II. Financing the Industrial Sector.

Industry in Lebanon has relied largely on self-financing and short-term credits, because it cannot rely on the capital market and is not provided with cheap long-term finance by credit institutions. The capital market is very badly organised and is subject to wild speculation which keeps the ordinary small saver - who is normally more interested in income and provides the stability[1] - out of it. Until the capital market is re-organised industry will have to rely completely on credit institutions for the provision of medium- and long-term credit which is the type of credit that it requires, and which so far is practically not available.

A plan for a credit institution that would supply such credits to industry was put forward in the 1950's by the late Emile Bustani[2] but it has so far failed to see the light of day.[3] His plan was to

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1. The role of the small saver in this context is sometimes disputed; is he a source of stability or instability? But unless there is a general panic as in 1929 in Wall Street, it is unlikely that all small savers will act in the same way or direction, and therefore, even if speculation rather than income is his intention, he is less likely to affect the market prices than the very large speculator.
2. A prominent Lebanese businessman and politician.
3. However, it is now reported (L'Orient, 9th February 1966) that following an Islamic Pact initiated by King Feisal of Saudi-Arabia and which is supposed to group all Moslem countries - i.e. not just Arab countries - a Development Bank will be created to help finance projects in these countries. Details have not been worked out yet but the idea is similar to that of Mr. Bustani's.

create a supranational Arab body called the Arab Development Bank which would make loans to National Development Corporations which would then finance on national levels various development programmes.[1] The essence of the plan was a planned economic development of the Arab countries but to be undertaken by the Arabs themselves and with the oil revenues earned by some of them and pooled in the Bank for the good of all.

As it turned out the plan was not adopted. Mr. Bustani was over-optimistic first about the chances of getting the "have" and "have not" countries together, and then about the oil companies' willingness to

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1. "What I am suggesting... is the establishment of an Arab Development Bank, financed by an annual deduction of ten per cent from the gross proceeds of all oil produced in the Arab world, and dedicated to furthering social development schemes in the transit States. This Bank would in effect, be owned and financed jointly by the producing countries and the oil companies, who would each be represented on the Board of Directors and have voting powers in proportion to their investments. Once it was launched, a National Development Corporation would be set up in every Arab oil-transit State, the national Government holding 50% of the shares and the remaining 50% being made available to private investors at par.

These Corporations would be entrusted by transit-State Governments with carrying out development schemes with the aid of money loaned to them by the Arab Development Bank at a nominal rate of interest - say two and a half per cent. Their proposals would, naturally, have to be submitted in detail to the Bank and fully approved before the loans were agreed."

The Arab Development Bank "... would be strictly a business enterprise..." and it would also "provide loans to privately owned businesses in the transit countries, for approved development purposes, provided that repayment was guaranteed by the National Development Corporations".

Provisions were also to be made for safeguards that would have to be given by transit countries regarding the protection of the pipelines.

E. Bustani, Doubts and Dynamite: The Middle East To-day, Allan Wingate, London, 1958, pp. 140-141. Italics are his. Transit countries are those which are crossed by pipeline but do not produce oil themselves.

agree on such a project. Moreover, it is doubtful whether Governments would have agreed to submit their various development projects for approval by the Arab Development Bank, which would have been a supra-national body on the one hand and partly owned and managed by the oil companies on the other hand. Finally the stress of the plan was mainly on government finance, and so private finance was not given enough attention.[1]

In any case in Lebanon medium- or long-term credits to industry could be supplied by the commercial banks themselves or by investment banks that could be formed with most or all of their capital subscribed for by groups of commercial banks. The first possibility has the advantage of requiring no further financial intermediaries which might increase the costs of lending, and is quicker and easier to undertake, especially in Lebanon where inherited business suspicions are strengthened by the very stiff competition that already exists in the money market.

The second alternative has the great advantage that it can permit a larger scale of operations: Lebanese banks on the whole tend to be small[2], and by pooling their funds they could:

a) have more funds available at any one time and thus avoid

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1. Another plan, but concerning finance for building only, was put forward in 1956 by Mr. Pierre Champion of the Crédit Foncier de France on the request of the Lebanese Government. It was never adopted. For details of the plan see: Le Commerce du Levant of 7th April, 1957.

2. Unfortunately it has been impossible so far to get any statistical indication about the size distribution of Lebanese banks, but there can be little doubt that on the whole they are small.

the necessity of setting up ad hoc consortia every time a big firm asked for a large loan;

b) spread the risks over a number of banks so that no one bank could actually be identified with a major default; and

c) avoid duplication of work and research, and take advantage of economies of scale, which might more than offset any additional expenses due to the introduction of an intermediary. Moreover they would have more and better means of assessing the credit-worthiness of borrowers and investigating the investment to be financed because they would be able to afford it.

The idea of an investment bank owned by other banks has recently been adopted in Germany. Thus in September 1965 the Deutsche Bank, one of the largest banks in Europe and the largest in Germany, and a few private banks, among them the Bank of Brinkman Wirtz und Co., and B. Metzher Seel Sohn und Co., which is very well known in Frankfurt and which came up with the idea, founded the Deütsche Kapitalbedeiligungs Gesellschaft which is intended to "help medium-sized private enterprise companies to find partnerships or capital. This would aid companies unable to approach the capital market for funds. Such enterprises would be able to contact the new subsidiary and get new capital by means of participations and also advice."[1] Each of the owner banks will bring in a capital of DM 1m. and has promised to submit more of its excess funds as necessary to fill the gap that was noticed to exist in the provision of long-term finance to small or medium-sized companies. If their funds were not sufficient, they would also endeavour to attract private capital and would advise the companies on the best way to get it.

The resources of the Lebanese investment banks, the number of which should be restricted in order to group a larger number of commercial banks in one large investment bank, will consist of:

a) <u>the capital of the bank</u> which will be subscribed by the commercial banks. Private individuals could be allowed to participate, but the majority of the shares should be held by the commercial banks which will then make sure that the investment banks do not lend on short-term thereby creating stiffer competition for the commercial banks, the co-operation of whom is needed.[2]

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1. <u>The Times</u>, 24th September, 1965, p. 16. Other information about the investment bank and its shareholders was obtained from private interviews with merchant banks in London.

2. Foreign participation might also help augment these resources. For example, Schroder-Wagg the London merchant bank has acquired an interest in a Lebanese bank, the Rif Bank S.A.L., of which the other main shareholder is the National Bank of Kuwait. Although the Rif Bank is a commercial bank, it is likely to concentrate gradually on investment and a long-term finance thus getting close to our idea of an investment bank. Schroders acquired their interest in January 1966.

b) <u>bank deposits</u>. Commercial banks will be able to deposit surplus funds now invested abroad, with the investment banks. These can be deposited in either or both of two forms:

i. as a sight deposit bearing interest. The rate will have to be calculated so that the sum of the return on the deposits plus the expected return on the capital invested by the commercial bank in the investment bank, is higher than would have been earned if the same amount of money - i.e. deposit plus capital subscribed - had been invested abroad. For if the total return was lower, banks would not be induced to employ their funds in Lebanon rather than abroad.

ii. as a time deposit against which the investment bank issues a cash certificate with a maturity date and which is negotiable and discountable at the Central Bank at a low rate. These certificates can be used as a means of payment in the clearing office. If a bank cannot find any other bank to buy the certificate when it is in need of cash it should be able to sell it to the Central Bank at a penal rate.[1] The discount is intended to discourage such a

1. The penal rate is intended to discourage a bank from depositing money in the investment bank - from whose operations it would receive a profit if it is a shareholder - and then rediscount the cash certificate to replenish its reserves and thus increase its own lendings. If that should happen it would be tantamount to a Central Bank deposit in the investment bank.

course of action and to make sure that other ways have been tried first. However, a bank should very rarely find itself in the position where it has to go to the Central Bank because the funds it will be depositing in this way are in the nature of long-term savings. Moreover, even if the bank should need the cash, the Marché Hors Banque with its foreign banks should be able to buy the certificate. The rate of interest paid on such cash certificates should be higher than the one paid on sight deposits to encourage banks to adopt this method for:

i. it simplifies the work of the investment banks as they know they will not have to repay the certificates before they fall due.[1]

ii. it decreases further the danger of inflation in so far as, if a sight deposit were withdrawn, the investment bank might have to rediscount some paper at the Central Bank therefore injecting new cash into the economy, while the certificate can itself be used as a means of payment with no deposits being withdrawn from anywhere. The certificate is discountable at the Central Bank but if that should

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1. All time deposits are technically not repayable until they fall due, but in practice a bank hardly ever refuses to repay a deposit on grounds of notice. These certificates will be in fact somewhat like the 'Bons de Caisse' which are issued in Belgium but to any person.

happen a penal rate is charged. Such a loss is not incurred in the case of sight deposits.

c. insurance companies deposits. Insurance companies have large amounts of money at their disposal which will go on increasing as the country develops and the standard of living increases. Moreover, their work is not restricted to Lebanon only but to the whole of the Middle East. At present, their long-term investments have gone mainly into tangible assets such as buildings and real estate. The reasons are mainly two: one is the belief that the safest asset is real estate, and the other is the lack of suitable alternative investment. Given a reasonable return on their funds these firms would take up cash certificates, as the vast speculation that has taken place in real estate has discouraged them from acquiring any more.[1] The cash certificates held by the insurance firms will enjoy the same facilities as those held by commercial banks; they will be negotiable and discountable at the Central Bank. This means that insurance companies will enter the money market every now and then, but that should not be frequent.

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1. Information gathered from private interviews with Insurance firms in Beirut in 1964. Firms interviewed included:

   Arabia Insurance; L'Union Nationale; and the Compagnie Libanaise d'Assurances.

The credits granted by the investment banks will be exclusively on medium- and long-term. They will take the form of ordinary bills but with longer lives than the usual three monthly ones. However, as a large part of their resources will consist of funds taken from the money market, the investment banks might be called upon to repay some of these funds at no notice. As already explained this should not happen very often, but a safeguard against such an occurrence should be taken and it is therefore suggested that the paper that is produced by such credits should be rediscountable at the Central Bank.

This means now that both the cash certificates issued by the investment banks and their long-term paper will be rediscountable at the Central Bank. But the former will be rediscountable by the commercial banks while the latter by the investment banks. In ordinary circumstances rediscounting should not be heavy, but if rediscounting from both sides is heavy or increasing, this should provide a warning to the Central Bank that a new situation is arising, which might require central banking action.

As noted earlier in this chapter safeguards must be adopted to prevent an abusive use of these credits and to make sure that funds are granted in a careful and orderly way. Such safeguards prevail in France but there it is the commercial banks that lend on medium- and long-term, i.e., there is not the intermediary role of the investment banks which we thought was advisable in Lebanon.[1]

Three safeguards can be adopted:

a) A requirement that at least three signatures are needed on the bill before rediscounting, one of the signatures to be that of a public monetary institution, other than the Central Bank. In fact, this means that it is this monetary institution that will present the bills to the Central Bank for rediscounting.[2] The reason for inserting an intermediary between the investment banks and the Central Bank is explained later on. Later, when the investment banks develop, four signatures could be asked for before rediscounting so as to ensure the prior use of surplus private funds deposited with other investment banks. Initially three should be enough.

The rediscount rate charged to the investment bank must be higher than the rate paid on deposits. Otherwise, it would prefer to rediscount rather than to endeavour to attract more deposits from commercial banks. The danger of inflation is thereby reduced.

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1. For more details see P. Simon et L. Pavès, Le Crédit a Moyen Terme en France, Presses Universitaires de France, 1957.

2. The first two signatures will be the debtor's and the bank's and the third will have to be the public monetary institution's.

b) Before the investment bank grants the credit it will have to obtain the approval of the monetary institution to which the bank might have to turn at a later date to rediscount the paper created by such a credit. A sanction can be applied here whereby any bill that is submitted for rediscounting by an investment bank at the monetary institution in question, will not be considered <u>unless</u> it carried with it the prior approval to the credit of the said institution, which will have to consult the Central Bank. This move would ensure that funds lent on medium-term are used for worthwhile projects benefiting the public interest.[1] Furthermore the Central Bank and hence the monetary institution will give or withhold their approval according to the monetary conditions of the country, and to an order of priority or projects which the Ministry of Planning will have set out. Finally, this procedure will be beneficial

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1. A delicate balance has to be struck here between efficient and desirable control and stifling bureaucracy. Provided no undue delays take place at the monetary institution our suggestion should have no stifling effect, for after all there would be only one more authority than the normal procedure examining the demand for such credits, and this is partly to the benefit of the banks. If they choose not to submit such demands for credit for approval, nothing will force them to do so, but they will not be able to rediscount paper issued for such unapproved loans. No stifling effect should be felt by the borrower as he would contact the investment bank only.

to everyone for it will make necessary a thorough investigation of the project by the borrower - as he has to present a convincing case - by the investment bank, and finally by the monetary institution and the Central Bank. The latter institutions will have to follow up and supervise the use made of the credits lest their original intended use is abandoned or deviated from. The investment bank might disagree with the verdict of the monetary authorities, and if it still chooses to go ahead and grant the credit, it is free to do so; but it will not in this case be able to rediscount this particular paper if it should prove necessary to do so at a later date.

c) At the beginning a five year limit - medium-term only - could be placed on the credits granted. This is not an hampering limit as the industrial sector, as at present organized, is unlikely to ask for longer credits, because it consists mainly of light industries where constant change requires quick replacement and rapid amortization. The time limit is set to reduce further the inflationary pressure that rediscounting might cause and to prevent abuse. Moreover, it is beneficial to have such a limit as long as the institutions concerned have not acquired sufficient experience to forecast and assess risks for periods exceeding five years.

It has been suggested above that a separate public monetary institution be required to give its prior approval to credits if they are to be eligible for rediscounting. The creation of such an institution, which might be called the 'Caisse Nationale de Reescompte'[1] could have both psychological and operational advantages. The Central Bank is looked upon as a sort of police of banks, and for the first time banks in Lebanon are now required to submit balance sheets regularly for its inspection. To require their subsidiaries i.e., the investment banks to ask for its permission before granting certain credits - they do not have to, but unauthorised assets are not liquifiable - would not be received very well, and a separate institution with separate funds would be more welcome. It might be looked upon as an institution created to help them rather than to police them, which is the way they look on the Central Bank, and their psychological attitude towards it would be very different. Secondly, the Caisse will have a specialised job, its primary purpose being the investing of public funds - the origins of which are described later. Although in certain under-developed countries Central Banks find it necessary to engage in investment, this is not necessary in Lebanon, and the advantages of decentralisation and specialisation can here be reaped, for it is then possible to recruit highly trained experts - not necessarily full-time - in the fields of investment whom a Central Bank would not normally possess, and who would

1. Public institutions in Lebanon usually have French names when they are not referred to in Arabic.

administer the Caisse within the broad directions they would have received from the Central Bank and the Government. Thirdly there is the question of interest rates. By creating a separate institution it might become easier to dissociate short-term rates from medium- and long-term rates.

The case for dissociating the rates arises from the fact that while short-term rates may sometimes need certain immediate adjustments, it may not be desirable for them to affect medium- and long-term rates. A complete dissociation of the two rates is not possible, but some dissociation can be obtained to a significant extent because in the plan outlined the influence of the administered rate, i.e., the Bank Rate, on the short rate on the one hand, and on the longer rates of the other hand, will be exerted in different ways. Thus while the effect on short rates will be felt immediately because the commercial banks rediscount direct at the Central Bank which charges the administered penal rate, the effect on the longer rates will be delayed because investment banks rediscount at the Caisse which has funds of its own and whose rate will be affected by the administered Bank Rate only if in its turn it has to rediscount at the Central Bank. Thus the effects on the long-term rates will be linked to the gradual exhaustion of the reserves of the Caisse. The introduction of this buffer institution should in fact accentuate the slight dissociation that normally exists between the two rates: the more temporary the rise or fall in short rates is expected to be.. the less will it cause long rates to rise or fall.[1] The Caisse should help in making this relationship looser. It could be argued that the Central Bank could perform this job, i.e., that there could be a department in the Central Bank specialising in this sort of business. But to be as efficient as a separate Caisse, this department would have to be entirely distinct from the rest of the Bank and it would be very much easier if it were given an identity of its own. The problem of interest rates is not a decisive argument for creating a separate institution: it strengthens the argument for having one.

The 'Caisse' will be entirely publicly owned. Its sources of funds will consist of:

a) its capital

b) funds deposited with it by public bodies and especially the public welfare institutions - social security, unemployment and medical insurance - which have just been created and will have considerable funds at their disposal,[2]

c) Treasury advances which can be the proceeds of borrowings

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1. See Newlyn W.T., The Theory of Money, Clarendon Press, Oxford, pp. 117-118, and Committee on the Working of the Monetary System, Report Her Majesty's Stationery Office, London, 1959. Cmnd. 827, par. 447.

2. As these welfare institutions have just been created, the deflationary effect of their coming into being will be offset by the use the 'Caisse' will make of the funds.

that the Treasury may make in the market[1]

d) profits from its own operations.

The Caisse will work in close collaboration with the Central Bank and the Ministry of Planning as already explained. But it should be free of any political influence, and of any pressure that might be exerted on it by either the Chamber of Industry or of Commerce. However, the advice of these two Chambers should be sought when the 'Caisse' examines the projects that will be submitted for its approval by the investment banks. Its board will consist of qualified people with no direct interest in industry or commerce.[2]

Now going back to the operations of the investment banks, the conditions under which they will grant the credits must be fixed. The ordinary rules relating to banking in general will apply here but two extra and very important conditions must be respected. They are

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1. Something on the same lines is done in France. The French Government issues securities, the proceeds of which are deposited with various monetary institutions to help them expand their credits. The capital market is not very developed in France. The possibility of Treasury borrowings will be discussed later in the Chapter,

2. In France buffer institutions between banks and the Central Bank exist but only because such public monetary institutions have been in existence for a long time, and the system has just grown that way. It is not as in Lebanon where a new institution has to be created. For details see P. Simon and L. Payès op. cit. In India a Refinance Corporation financed by the Central Bank, the Government and the commercial banks, fulfils the role ascribed to the 'Caisse'.

necessary to prevent abuse and because the risks involved in that sort of operation are longer and more difficult to assess than those involved in short-term loans. One condition is that the borrower must prove that other sources of the same type of finance have proved dry. The other is that repayment should be made out of profits and not through a loan from some other bank. If there are no profits within the specified repayment period an enquiry will be opened by the bank to help it decide what steps it should take next. An easy way of detection would be to ask for the balance sheet of the borrowing firm, or to consult the Centrale des Risques which was described in Chapter II and which would inform the bank about all the loans facilities granted by member banks.

Beside granting medium-term credit, investment banks can help industry by underwriting new issues whether of securities with fixed rates of interest, or equity shares. This implies the acceptance of the principle that these banks may hold such assets in their portfolios. In fact the principle is officially accepted in certain countries, for example, in Ireland where the Commission on Banking Currency and Credit[1] saw no objection to the banks' underwriting securities of fixed interest provided that the amounts involved represent only what it calls a reasonable amount in relation to the total resources of the banks involved. It also saw no objection to a bank underwriting commercial

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1: Commission on Banking Currency and Credit, Report 1938. Dublin Stationery Office.

issues provided the commercial undertaking was intimately known to the bank. Although the practice exists already in certain countries it is by no means general, and, on the whole, legislation limits severely the proportion of assets that may be held this way when funds come from the money market. In Belgium, legislation came in the 1930's: it was found that commercial banks were heavily linked to industry, so the law forced them to discontinue this association and to limit their activities to short-term loans.[1]

In Lebanon investment banks will be able to engage in such business because the funds they will be working with have the same character as funds which in - say - Britain would have been invested in industrial or government securities anyway. Such opportunities do not exist in Lebanon for the small and private person. The investment banks with their greater knowledge and experience can underwrite the issues and hold whatever is not sold. But in so doing the investment banks will have to guard themselves against a possible conflict between their interests and the client firm's interests. If the bank underwrites an issue for a firm to which it has already granted a credit, it might be interpreted as indicating a lack of confidence in the firm's ability to repay and the bank might be suspected of having advised it to appeal for a public subscription. The procedure will have to be carefully worked out.

1. For details see Sayers R.S., ed. Banking in Western Europe, 'Banking in Belgium', by Sylvia M. Johnson and R.S. Sayer, Oxford University Press, 1962, pp. 234-258.

The reasonable proportion of shares and securities which banks can safely keep in their assets will have to be determined by experience.[1] But in order to avoid the continuous control of certain firms by the banks, and to give all industrial firms a chance to use the banks' issuing facilities, the latter can be forbidden to hold shares or securities of an individual private firm for more than - say - five years, and to buy them again before two years have elapsed since their sale.[2]

The investment banks can also extend the needed short- and medium-term credit to the Hotel Industry, which at present can obtain only expensive three-monthly renewable credits. Long-term credit for the construction of new hotels, which will have to come about with the expansion of tourism, would be more appropriately provided by the Development Bank which is discussed later.

III. Financing the Agricultural Sector.

The financing of agriculture raises problems that differ considerably from those raised by industry and commerce. This is especially so in Lebanon where small land-holdings prevail. Agriculture involves heavy investments in illiquid assets relatively to the annual turnover

1. The propórtion will be lower as long as the capital market is not properly developed and regulated, and therefore the issues not very marketable.

2. If this line of the Banks' business goes totally unrestricted one might see a kind of the Japanese style Zaibatsu emerging in Lebanon with banks controlling the whole economy.

that can be obtained. A merchant adjusts much of his investment to market conditions. With experience he knows how much he should keep in stocks and he usually tries to keep them to a minimum. His fixed investment is flexible and relatively easily adjustable to market conditions. In the case of industry, and especially in Lebanon where light industry is the common feature, a proportion of assets has to be fixed, but in relation to the annual turnover, it is lower than in agriculture: the cycle of production is much shorter in industry than in agriculture and this usually means a larger turnover relatively to fixed capital.[1] Whereas the farmer receives the proceeds of his production once a year - in Lebanon at least - while he has to spend all year round to produce, an industrialist replenishes his cash balances more often and a great part of his expenditure on production is directly linked to sales. His expenditure -income period is much shorter than in agriculture.

Another difference is the kind of security that industrialists and farmers can give to receive a loan. A small farmer can offer his land or his future produce as collateral. Land is one of the most illiquid of assets to offer as a collateral and furthermore raises the problem of valuation. Offering the future produce raises also problems of

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1. Except in very large industrial concerns where automation has required an intensive mechanisation of production. In this case, as in most heavy industry, fixed capital is a high proportion of annual turnover.

valuation, for its value will depend on many factors outside the control of the farmer: e.g. market price and crop yields (which depend partly on the weather). Also, his cycle of production sometimes may run unexpectedly over 12 months or two years. In the case of industry more easily realisable and valued collateral can be offered. Present stocks are one example, and even when a five year credit is granted, industry always keeps a certain amount of its assets in stocks.

Therefore agriculture needs permanent credits quite large in relation to the annual turnover of production, and for the most part repayable on a long-term basis. On the other hand the kind of security it can offer is difficult to evaluate and to realise in case of default.

A direct appeal to the money market for the funds it needs without a buffer institution would be unlikely to meet any success. The problem of agriculture is different from that of industry, as explained above, and that is why it would be preferable to have a separate institution to supply agriculture with the type of credit it requires. This institution could be an agricultural bank basically similar to those of other countries. But it may be preferable to call it the National Development Bank in Lebanon because it will be called upon also to provide long-term credits for the construction of hotels.

A completely private institution is unlikely to provide agriculture with the type of credit it requires without some sort of guarantee from the Government. Moreover, such an NDB will have to attract funds from both public and private sectors. Therefore, a direct stake by the State is necessary, and a State bank which can sell bonds to banks and private individuals could perform the work. However, a case can be made for a private minority equity holding in the NDB, at least initially. Since the issue of bonds is something totally new in Lebanon it might be preferable at the start not to flood the market with them but to keep bond-issuing for Government finance (which is considered later in the chapter). So, the alternative is for the NDB to try to attract deposits from the other banks and this will be easier to achieve if the latter have also a stake in it. The same results as if it had been completely state-owned will be obtained, for, if the private holding is limited to 49% of the total, the State still holds the majority of shares and therefore can steer the NDB onto the course that is thought to be best, while at the same time it attracts funds from the private sector.

However, if banks are to take a minority interest in the NDB they will need an inducement. There are two ways in which this could be done. The first one is suggested by the experience of the Industrial Bank of Japan.[1] The State can guarantee to the banks a minimum dividend of 5%

1. For more details on this and other such institutions see W. Diamond, Development Banks, John Hopkins Press, Baltimore, 1957. Published under the auspices of the IBRD.

over a certain number of years. The 5% figure is an average of what the banks get on bills purchased abroad. Another inducement could come from the Central Bank: if alteration in reserve requirements were to be used as a means of credit control, funds invested in the NDB could count as part of the reserves. The great inducement here of course is that they would be earning a 5% interest whereas if they had been deposited at the Central Bank they would have been sterile. Moreover, banks can be permitted to deposit money with the NDB. Any such money deposited before a decision to increase the ratio could count as part of the reserves too. This should not force the Central Bank to raise reserve requirements higher than otherwise unless its aim is to contract the total amount of credit outstanding. But generally the aim is to put a brake on the expansion of credit, and freezing such excess funds deposited at the NDB which could have become the basis for a further expansion of credit by the banking sector - as opposed to the State-controlled NDB - will be just as efficient as it would have been had these funds been deposited not with the NDB, but with the Central Bank. Such a procedure, beside giving the banks an incentive to deposit with the NDB, need not be a danger to the general policies of the Central Bank and the Government, because the State, as a majority shareholder, in the NDB could make sure that a non-inflationary use be made of the funds. A close collaboration with the Central Bank would therefore be necessary.

The resources of the NDB will consist of:

a) capital subscribed by the State and the commercial banks

b) loans from the Ministry of Finance

c) time deposits by commercial banks which will receive interest. The general public should not be able to deposit with the NDB, as it should not compete with commercial banks if it is to benefit from their co-operation.

d) debentures which it would issue at a later date to supplement the banks' time deposits.

Some of these resources will come from the money market but all can be used by the NDB for long-term lending. In effect loans from the Ministry of Finance and debentures have fixed and distant maturity dates. This makes it easy for the NDB to time its advances according to its repayments schedule. The banks' time deposits could also be used for long-term lending because beside the nature of such funds which has already been described, there is a further incentive not to withdraw them from the NDB - except in extreme circumstances of course - because they would be considered as reserves by the Central Bank if the need arose.

There is however one problem which may arise when the NDB decides to acquire more funds by the issue of debentures. We have mentioned on several occasions that the capital market in Beirut is underdeveloped and that it cannot be relied upon for the provision of funds. One of the main reasons is its highly speculative character. Debentures do not normally fluctuate very much but a drought in Lebanon could involve the NDB in losses - as in such cases loans should not be called in - which could cause people to speculate on the future of the interest payments[1] and lead them to sell heavily at any price, unless it is known that in such occurrences the NDB would be subsidized by the State. However this may not be enough as any issue in Lebanon can be subject to speculation because of the lack of organisation in the capital market, and thus a guaranteed price on those debentures is necessary to convince people to buy them. The main measure that could be taken is to give the Central Bank the powers to limit the fluctuations of these debentures. This implies that the Central Bank would enter the market for such debentures buying when the price falls and selling when the price rises. In fact, as the upper limit is automatically fixed by

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1. A reduction or temporary cessation of interest payments is not unheard of in the world of finance. Thus in the spring and summer of 1965 the business conditions in Japan and its balance of payments position were such that there was a widespread fear that the very high interest of Japanese securities - including Government securities - $6\frac{1}{2}$ to 7% net - might be halved or their payment suspended for some time. There followed substantial sales of these securities in the markets where they were issued, and their prices dropped sharply.

the fact that this is not a growth stock, only the lower limit needs to be checked.

The NDB is designed to meet the credit requirements of the agriculture sector with short term credits up to eighteen months, and long term up to twenty years. The eighteen months credits can be used to finance current production. Thus they can be used to purchase fertilisers, seeds, small tools and to hire labour. The security against such loans can consist of the machinery in use or the produce of the borrower. They will take the form of ordinary bills but with longer lives, and should be rediscountable at the Central Bank in case commercial banks face difficulties and have to withdraw their deposits. As the NDB is already a semi-public institution with a majority holding by the State, no official prior approval of the credits - as required of the investment banks - need be required here.

The long-term credits should extend up to twenty years. These credits can be used for direct investment in land and for helping agricultural institutions such as co-operative societies in rural areas. Rough estimates of such new investments were produced in Table XVI. In this field of its activities the NDB will have to work closely with the Ministry of Agriculture and Ministry of Planning, for in considering the demand for such loans the NDB should have regard to the development of the region in which the credit will be spent and thus should work out a list of priorities. The guarantee for long-term loans can be the land of the borrower. It may be inadvisable to make paper issued for long-term loans eligible for rediscounting in order to make sure that the NDB tries first to attract more deposits and rediscounts its shorter bills. If it is unable to raise enough funds in these ways, the Central Bank can then help it to issue new debentures or advance money against the security of long paper. This would give the Central Bank a new weapon of monetary control for it could then time such advances, which it could not do with rediscounting. The alternative would be to set arbitrary ceilings to the amounts that can be rediscounted at certain moments.

The NDB will also extend long-term credits to the hotel industry. These will be needed as the expansion of tourism will necessitate the construction of new hotels. The NDB should be prepared to accept mortgages for such loans.

IV. Financing the Public Sector

In Chapter III the State five year plan was outlined and it was estimated that if the 9.5% yearly increase in the ordinary budget was adopted expenditure will exceed receipts by £L 823.1 million.[1] If the

1. We are assuming that 'new projects' will be carried out. See Chapter III pp. 159-160

Planning Commission's recommended annual increase in the ordinary budget - 6% - was adopted the deficit will be £L 663.5 million over the five-year period.

By spreading its capital expenditure programme over a larger number of years, it might be possible for the State to finance its development plan without incurring a deficit. But this was rejected by the Planning Commission as it meant another delay in the use of the country's idle resources. Besides, such a spread would not help to solve the social problem described in Chapter III. So the State is committed to carry out its development programme as outlined in its five-year plan. What has not been agreed upon is the financing of the expected deficit.

One possibility is to increase State receipts by a major tax reform, mainly income tax. But this was ruled out by the Planning Commission because "it seems that in the economic and social environment of to-day it is difficult to obtain in the immediate future such reform".[1] Another possibility ruled out by the Planning Commission is to resort to a Reserve Fund constituted of accumulated budget surpluses and unspent appropriations. The Fund is the reservoir which has been used to feed the Treasury in the carrying out of public investments. From Table XXIV it seems that the Fund was used only once - 1962 - to

1. Report of the Planning Commission to the Ministry of Finance, 1965. Unpublished.

TABLE XXIV

CHANGES OF THE RESERVE FUND

In £L millions

Year	Budgetary Operations		Receipts of non-budget origin	Non-budgetary Withdrawals		Balance receipts - expenditure		Credits	Debits	Balance
	Receipts	Expenditure		Development	Telephone	Positive	Negative	4 + 7	5+6+8	9 - 10
1	2	3	4	5	6	7	8	9	10	11
										65.6
1953	141.2	96.3	-	12.7	-	44.9	-	44.9	12.7	32.2
1954	157.4	111.2	-	21.3	1.7	46.2	-	46.2	23.0	23.2
1955	178.9	132.4	-	18.3	1.6	46.5	-	46.5	19.0	26.6
1956	192.0	161.3	-	58.9	1.6	30.7	-	30.7	60.5	-29.8
1957	209.9	192.5	-	22.2	1.0	17.4	-	17.4	23.2	- 5.8
1958	225.5	181.6	2.0	17.1	-	43.9	-	45.9	17.1	28.8
1959	250.4	198.6	-	16.4	6.2	51.8	-	51.8	22.6	29.2
1960	316.6	243.0	0.7	11.7	2.5	73.6	-	74.3	14.2	60.1
1961	313.4	269.3	-	3.0	0.5	44.1	-	44.1	3.5	40.6
1962	360.1	415.3	-	-	-	-	55.2	-	55.2	-55.2
	2,345.4	2,001.5	2.7	181.6	15.1	399.1	55.2	401.8	251.9	215.4

Source: Ministry of Planning, Beirut

cover a budget deficit. This possibility is ruled out because it is expected that the Budget will no longer show surpluses and appropriated credits will be spent according to plans. The Reserve Fund will thus be deprived of its two sources of funds and consequently will no longer be adequate to the financing of the development projects.

Borrowing is another possibility, but raises the problem of method. The Government could ask the Central Bank for the loans it requires and the Bank might supply it with the amounts and the type of loan demanded. Judging from the nature of the banks' deposits most of them are actually savings; this means that the new savings derived from the extra incomes generated by the increased money supply would swell banks' deposits further, and thus increase the resources of the banking sector which were described and discussed in Chapter II and earlier in this chapter. In other words such a borrowing would shift S_{dp} and S_{LL} to the right in figures 2 and 3. Om in figure 3, i.e., amounts demanded on short-term, might increase with the new activity engendered but Om' certainly will and this might mean an increase in mm', i.e., an increase in the foreign investment of the banks putting a strain on the reserves as Lebanese Pounds would have to be converted into foreign currencies. Such a creation of new money would be damaging to the confidence in the Lebanese Pound.

Another type of borrowing is external borrowing. This is normally chosen when the purchase of illiquidity or non-consumption by the State at home is either impossible or too costly, or else has undesirable effects on the terms on which private debt can be secured and on the level of interest rates. When this is not the case internal finance by way of bond issue, which is the third type of borrowing, is preferable since no foreign liability is thus incurred. So if it can be shown that internal finance is possible and will have no adverse effects on other economic activities in Lebanon the Government should prefer it to external borrowing.

At the beginning of this chapter it was shown that in the market for short-term funds there is a deficiency of demand at R_h rate of interest and that the elasticity of supply is infinite until Om' funds are lent. It was also shown that to make up for this deficiency in home demand, banks convert their excess holdings of Lebanese currency into foreign currencies and invest the proceeds abroad at a rate of return R_f higher than R_h because of the exchange risks incurred. (figures 3 and 4). So, if somehow the demand curve D_h can be shifted to the right they would divert their funds from abroad for investment at home. Now the State needs finance capital for its development projects and the kind of finance it requires is medium- or long-term, which means that it will have to issue medium- or long-term bonds. Normally the demand for such credits is not met with funds from the money market, but it was shown that it was possible and not dangerous to do so in Lebanon provided the bonds possessed one of the characteristics of short-term paper, namely liquidity. It was also shown why this provision was not in itself dangerous. A Central Bank will have a big role to play if the bonds are to be marketable. If that can be done it is plausible to expect banks to take up these bonds since they buy their equivalents abroad, provided of course they receive at least the same net rate of return on them. Now if we add[1] this demand for medium- and long-term credits by the State to D_h in figure 3 the result will be a shift in the curve to the right. The intersection point with the supply curve will move to the right as a fuller use is made of the country's monetary resources.

So far, the case for internal borrowing is stronger than a loan from the Central Bank because rather than creating new money, it will permit the orderly channeling of the large amounts of savings now available in the banking sector into worthwhile projects; and it is also stronger than the case for external borrowing which is tantamount to the creation of new money too and is therefore subject to the same criticism as a Central Bank loan - but with the qualification that reserves to the currency are increased initially with the import of

1. See p. 186 above.

foreign funds; it is also preferable to external borrowing because no foreign liability is thus incurred.

But would internal borrowing have no adverse effects on the economy? This will depend on the future shape and position of the total demand curve D_h. This curve represents now the total demand for funds, i.e. short- medium- and long-term from both public and private sectors to the banking sector. As shown in Chapter III the State demand will be substantial and it may be asked whether this will not affect the terms on which private debt can be secured, and the level of interest rates. It should be clear at this stage that as long as the total demand cutve D_h intersects the supply curve R_hPS_{LL} at a point between P and R_h there will be no effect on the terms on which private debt can be contracted nor on the level of interest rates as the amount mm' of the total R_fC (figure 6) which is invested abroad is a residual of what is not invested in Lebanon (figure 4.). In other words the State would not be competing for funds with the private sector, as long as the intersection point of the supply and demand curves in the local market is between P and R_h (figure 3), and as long as this is the case internal borrowing is not only possible but also has no adverse effects on the economy.

Nevertheless, it is conceivable that the total demand curve for the banks' resources D_h might, after some time has elapsed, intersect with the supply curve beyond the point P. If that should happen, there would develop an upward pressure on interest rates. However, on the one hand, to start with the backlog of demand for medium- and long-term credits from the private sector will almost certainly be spread over a few years until the new conditions for granting such credits are well understood by the potential borrowers. It is very likely that adaptation to the new conditions will take some time as borrowers were for example until 1964, never required to produce proper balance sheets,[1] and have never been asked to present proper cases justifying their investment projects.[2] Moreover, the issue of Government bonds will be gradual and therefore the demand curve D_h will not immediately be either shifted or flattened. On the other hand, while demand grows and more investment takes place at home thanks to the new facilities, supply conditions will change because:

a) the funds available in the banking sector will grow at a faster rate than before because of the increased economic activity. This will increase further the amounts available for investment from that source.

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1. The new law creating the Central Bank does require the banks to ask for a balance sheet before granting a credit.

2. An earlier IBRD plan to provide medium-term credit failed to produce any result because cases were not properly presented and justified.

b) insurance companies might be interested in buying suitable long-term Government securities. Their funds, though unknown, must be substantial considering the range and scope of their activities throughout the Middle East.

c) private Lebanese individuals might consider investing in Lebanese securities some of the funds now invested abroad and yielding equivalent rates of return. The advantage of investing at home is of course much easier access to market and better knowledge. Besides, lower expenses are involved in investing at home than abroad.

d) Foreigners, especially those from the neighbouring countries who tend now to by-pass Beirut or use it simply as a spingboard for their investments in Europe and America, might be encouraged to buy the securities thus offered. This is reasonable to expect because until recently their investments were actually made in Lebanon in real estate and it is only when their investment policies became more sophisticated, that they chose to go to the capital markets of Europe and American where opportunities non-existent in Beirut were available. If these opportunities for investing were made available in Beirut they could be expected to take them up because of the proximity of the market and the common language.

These supply changes will have two effects: one is to shift the supply curve S_{dp} in figure 2 to the right and with it, R_hPS_{LL}. This would increase the funds available in the banks thus shifting P further to the right, as the intersection point with the demand curve moves closer to it. Another effect is to shift some of the demand for funds on to new sources of supply - capital market - thus easing the pressure of demand on the banking sector and keeping the intersection point with the supply curve to the left of P. Thus it is improbable that by borrowing at home the State would cause any adverse effects on the rest of the economy, and since no foreign liability is incurred with internal finance, it is to be preferred to external finance.

But it should not be forgotten that the State will be competing for funds at present invested abroad, and that although the banking sector will be the main lender, other classes of lenders may appear. Their preferences vary according to their businesses, personal positions and the constraints that their liabilities place upon them. Thus while banks prefer highly marketable and therefore liquid investments, insurance companies go for long-term and not necessarily liquid investments. Private individuals would be interested in easily liquid - ated obligations especially in Lebanon where people are highly influenced by changes in the political situation of the Middle East. Therefore, competitive terms will have to be offered and the preferences of the lenders will have to be catered for.

> "The answer lies in a mix of various types of obligations. Determination of the most efficient mix of public debt involves two steps: First, there is the appraisal of market preferences, or the cost at which various types of obligations may be placed. Second, there is the more difficult task of appraising the relative degrees of illiquidity or non-spending, that are secured by borrowing a given amount through the sale of various types of obligations. Only if both factors are considered can we determine which mix provides the most efficient policy".[1]

The implications of this for a Central Bank are considered in the following sections.

V. General Implications for a Central Bank.

Unlike most underdeveloped countries Lebanon seems to have funds to finance her economic development. But these funds are not available in the capital market where they are wanted, but in the short-term money market where at the prevailing rate of interest there is a deficiency of demand: thus while there are no adequate credit facilities at the long end of the market for funds, there is an excess of supply at the short end. The main responsibility of a Central Bank will be to bridge the two ends. This role can be performed only by a Central Bank because of its unique position as the final supplier of cash.

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1. Musgrave R.A., The Theory of Public Finance, McGraw-Hill Book Co. Inc. New York 1959, pp. 582-83.

Given this responsibility, a Central Bank in Lebanon will have to have the power of holding in its portfolio medium- and long-term paper instead of the more common practice of short-term paper only. This is essential if the resources of the money market are to be used in the capital market. In particular with relation to industry, under the plan set out earlier in this chapter, a Central Bank might be called upon to rediscount medium-paper to the 'Caisse Nationale de Reescompte'. Without this guarantee the investment banks would never feel safe in lending on medium- and long-term, nor would commercial banks commit any funds to the investment banks. With relation to agriculture a Central Bank might be called upon to rediscount the eighteen months bills which the NDB will be holding as a consequence of the short-term credit it would have granted. With relation to State finance for which again the main source of funds will be the banking sector, a Central Bank will have to be empowered to buy medium- or long-term State securities to meet an emergency in that sector, or a temporary need for cash.

Besides having the power to hold medium- and long-term paper a Central Bank will have responsibilities for each sector under the plans outlined above. In the case of industry it will have to work closely with the investment experts of the 'Caisse' and the Ministry of Planning since it will have a say in approving or not approving specific projects. It will be remembered that the prior approval by the Caisse of the credit is necessary if at a later date it should prove necessary to rediscount the paper issued from such a credit. In this context the Bank will consider the monetary aspect of the projects particularly with respect to the timing. In the case of agriculture a Central Bank might have to help stabilize the debenture issue the NDB might make.[1] It could also influence the timing of the long-term loans the NDB will make by direct advice to the Ministry of Planning and by regulating its advances to the NDB against long-term paper. In the case of the State, a Central Bank which will issue the State debt will have to determine the most efficient mix of public debt as described earlier, and will have to time such issues according to the economic conjuncture.

The next thing that has to be considered is the consequences of making the new facilities for medium- and long-term credits available and the implications for a Central Bank in that respect. If the proposals outlined above are adopted the first such consequence will be a shift of investment from abroad to Lebanon. Therefore one such conse-

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1. See pp.211-12 above. This implies that the Central Bank will be helping to stabilize the issues of a partly privately-owned institution. The action of the Central Bank would here be similar to that of the Deutsche Bank which, as holder of what is called a 'regulating' parcel of 10m. marks nominal shares in Lufthansa, the German airline, helps to stabilize the price of the shares.

quence is an increase in domestic investment. This will mean a higher level of economic activity, and as the level of imports is directly linked to the economic activity of the country a further deterioration in the balance of trade is to be expected if exchange rates are kept stable.[1] But the overall position in the balance of payments presents no problem in Lebanon as noted earlier. Another consequence of the suggestions is that as new investment opportunities are created one can expect the capitalists of the neighbouring oil-producing countries to take an active interest in them, and no longer use Beirut merely as a spring-board for investment in Europe or America. Thus, after a few years one may expect an increase in the capital inflow, part of which will swell banks' deposits. This will mean in terms of figure 3 at the beginning of this chapter a lengthening of the part of the supply curve R_hP (as S_{dp} and S_{LL} will shift to the right). If the demand for funds does not keep pace with the supply at a rate of return at least equal to their minimum limit, banks will again find it preferable to invest abroad. The reactions of the private individual will be very much slower, but, on the whole, if the prices of securities go up (the rate of return drops) - as is more or less to be expected in a capital market where the supply of funds tends to grow faster than the demand for them - any new foreign and private capital

1. For a long time the level of the exchange rate of the Lebanese Pound was kept determined by market fortes only although an Exchange Equalisation Fund existed (see Chapter V). However, the new Central Bank is expected to take a more active role in the foreign exchange market and to stabilize the dollar rate at around £L 3.08.

flowing in will again use Beirut as a spring-board for investment in Europe and America and again tend to by-pass it, as is starting to happen at present.

However, there is a strong case for not allowing this to happen, i.e., the total demand curve D_h should continually tend to approach P in figure 3. The reason is that it will help to strengthen the services sector as will be explained later. So the problem is whether it is possible to create investment opportunities all the time: the solution is that if for one reason or another they cannot be created in Lebanon, they should be imported. In other words other countries should be encouraged to float loans in Beirut, and that is tantamount to making Beirut an international capital market. But what are the chances of Beirut becoming an international capital market and what could the Central Bank do that would help in this direction?

Beirut's geographical position and historical tradition make it a natural meeting point for lenders and borrowers of funds. Beside being for centuries the link between East and West and possessing all modern means of communications, Beirut is in a part of the world where the oil industry brings in more revenue than can be spent on developing the region, and shares a common language with all the suppliers of funds. But natural advantages are not enough as Beirut will have to compete with established and powerful capital markets, and so to supplement the favourable natural factors competitive terms must be provided to attract such business. No such business can be attracted if bankers are not able to provide a comprehensive service. The Lebanese banking sector is highly developed and, far from being inexperienced in foreign practices and capital markets, banks have had to keep in constant touch with them through their foreign investment. And eventually the investment banks described earlier should acquire enough experience and know-how in the issue of Lebanese stock and securities to offer their services to borrowers abroad. To attract foreign borrowers terms regarding interest and costs will have to be made competitive because a borrower always seeks to raise money at least cost. Loans raised in Beirut may be cheaper and quicker than those raised abroad because the proximity of the market allows the lender to make on the spot checks of investments not involving expensive long-distance communications, which can often cause much delay. Tax concessions would be granted both lenders and borrowers. A foreigner who holds securities in London, for example, is liable to death duties when he dies. Foreigners investing in the Lebanese market could be exempted from such a tax. As regards the costs of raising the money, the investment banks should aim to keep them at a minimum to attract the foreign borrower. Their experience in the domestic market, the smooth working of which depends so much on the Central Bank's co-operation, should help them to keep costs down.[1] A Central Bank in its special position at the top of the financial structure of the economy may be able to provide advice and information regarding the issue of loans. It could also ask the Government - and would have to check on such actions - to exempt from taxation any profits made by the investment banks in issuing securities for foreigners. Finally, a large part of the problem is a question of public relations and a discreet campaign intended to make the Lebanese banking sector better known abroad will help the banks in their hunt for new business. This will again help to reduce the banks' costs and therefore the commission to be asked from the borrower.

From the lender's point of view what is required is confidence in the banking sector[2] and especially in its stability. What is also required is a guarantee that any loans the banks consent to finance are repayable in the same currency, e.g., if a Kuwaiti buys a security quoted in dollars he will like to have a guarantee that at maturity he will receive dollars which he will be free to use the way he likes. This implies that people - at least non-residents - will continue to be able to have accounts in any currency they choose in

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1. A bank like the Rif Bank would have no such problems as the technical know-how of Schroders would be available to it. See footnote 2, p.١٩١

2. Confidence in the credit worthiness of the borrower is of course required but this is independent of Lebanon.

Beirut. This is not exactly a guarantee of full convertibility although this will be required if private Lebanese investors are to take up some of these foreign loans.[1] Another guarantee that will be required is the freedom of capital movements, and finally the undertaking that no new tax will suddenly diminish the income from the securities.[2]

The responsibilities of a Central Bank in this respect will be to strengthen the banking sector and to guarantee the convertibility of the Lebanese Pound at least to foreigners. The first responsibility can be discharged by keeping a close watch on the activities of each individual bank. Although the banking sector in general is very liquid not all individual banks are in the same position. If one bank fails - as one did in March 1964 - repercussions are bound to be felt in the rest of the Lebanese banks for they do not yet enjoy the same full confidence that people have in foreign banks. A constant watch will not only force a bank to keep its balance sheet in a reasonable shape; it will also have a psychological effect on the customers of the banks, whose confidence in the banking institutions will be enhanced.

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1. The Lebanese Pound is not an international currency and it is unlikely that loans will be raised in Lebanese Pounds.

2. This has happened recently in Germany, but the aim was to stop the inflow of capital and the new tax applied only to domestic Deutsche Mark bonds. Foreign loans expressed in Deutsche Marks are exempted from the 25% withholding tax.

Finally, the Central Bank can help the market by taking an active part in it. This means that it should be allowed to buy and sell foreign securities quoted in the Beirut market and denominated in currencies convertible into gold. This will be possible if the authorities stop their policy of keeping a 90% gold bullion cover to the note issue. This practice has been beneficial in the past as will be explained later[1], but as people become more sophisticated in their investment decision, they also become sophisticated in their conception of what is a strong currency and so a high gold ratio should no longer be required. At present the law requires the Central Bank to maintain a minimum of 50% of the note cover in gold. Therefore, without even changing the law a great amount of the gold holdings in the note cover could easily be sold and the proceeds used to buy foreign securities in the Beirut market. These securities which bear interest could then constitute part of the note cover.

Beirut does stand a chance of becoming an international capital market, especially now that traditional capital markets are nearing capacity,[2] but official support from the Central Bank is needed at least in the initial stages. The role of a Central Bank will not be merely to supervise the activities of each individual bank - although this is part of its role - but also to help banks to establish a

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1. See Chapter V, p.255

2. See J. Rothschild, "Raising International Funds through London", The Times 24th and 25th February 1966.

market which will attract capital to Beirut even when the domestic demand is saturated. The advantages to be reaped from such a market will be mainly in the services sector.

What a Central Bank can do for tourism has already been discussed in relation to the hotel industry. What it can do for banking is to create those conditions under which foreign money will continue to flow into Beirut; in other words, it should help the banks to start an international capital market. This will help the services sector for:

a) Before being invested, accounts will have to be opened for the funds with banks in Beirut which will collect the dividends and hold the securities. This will mean

b) An extra income to the banks in the form of commissions and fees which will

c) Help the invisible earnings which are very important in the balance of payments.

d) It will also mean higher deposits as minimum balances are usually kept by investors.

e) As banking secrecy is a law in Lebanon, more funds seeking a financial haven will flow in because of the publicity that the market will have given to the banking sector.

f) The financial activity created will increase:

i) the re-exports which are important in the balance of payments

ii) the general economic activity in the country and especially exports as Lebanese goods become better known.

iii) the general interest of foreigners in Lebanon which will encourage tourism.

Thus by developing the financial potentialities of Lebanon it may be possible to help all sectors of the economy. It is no longer a question of one sector developing at the expense of another one - as the industry versus commerce rivalry seems to suggest - but of all sectors developing and expanding and economic activity approaching an optimum position. It is true that their order of importance in the National Income might change but this is just because some sectors will be expanding faster and will be able to absorb the resources of the economy at a higher rate than others.

This raises another problem. If the plans outlined above are adopted, it is probable that in spite of the safeguards provided, the increase in domestic investment which will result might cause some overheating in the economy and bottlenecks might appear here and there calling for central banking action. It is interesting to consider where the inflationary pressures would be most strongly felt, as a result of the increase in domestic investment, and a quick look at the period 1950-1962 might prove useful in this context. In that period the purchasing power of the Lebanese currency was kept remarkably stable relatively to other countries and in spite of the large inflow of capital. Official statistics show that the wholesale prices index was practically stable throughout the period: from 100 in 1950 it rose to 101 in 1962. The cost of living index rose by 24% only over the whole period.[1] It might be asked how did Lebanon achieve this result. The answer lies in the consideration of the Lebanese consumer goods market, for it shows that the largest part of the goods consumed is imported: thus their prices depend on factors outside the Lebanese economy, and when demand increases imports are increased.[2] To a great extent inflation is imported in Lebanon because the general price level is heavily dependent on imports prices. Moreover when the prices in one foreign market rose relatively to those in another market,

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1. Statistics quoted by Mr. H. Bourguinat in "Regards sur l'Economie Libanaise", L'Orient, 9th, 10th and 11th June 1965. The Economist Intelligence Unit compiles an All Items Index of the cost of living in its Quarterly Economic Review. From 100 in 1963 (base year) the index rose to 117 in 1959. The index was revised in 1959 and 1958 was taken as base year (100). On the new basis the index was 109 in 1963. The EIU's estimate seems to support the point that the cost of living in Lebanon rose less sharply than elsewhere. A reservation must be made about the accuracy of such indices: they are very rough and are obtained by considering prices in Beirut only which, however, tend to show the largest increases.

2. Trade deficits present no problems in Lebanon.

the Lebanese merchant was quick enough to switch to the cheaper one because of the stiff competition he faced when he came to sell his goods at home. This explains why the cost of living rose at a slower pace in Lebanon than elsewhere.[1]

Thus an inflationary pressure in Lebanon to-day is likely to be felt most strongly in those few fields where importation is impossible or difficult, i.e., where supply is inelastic and this is mainly in the supply of services and possibly some food products. Housing and building might be affected but probably not in the early stages as it is believed there is at present an excess supply of building materials.[2]

As industry develops and a larger proportion of goods consumed is produced locally one could think that the cost of living would become more dependent on the economic situation in Lebanon. However, this would occur only if highly protective tariffs are imposed, for otherwise imports would play the same role as they are doing now. But also as industry develops and becomes a larger contributor to the national income there might come a time when it could place a large strain on certain resources[3] which cannot be imported very easily. The price

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1. This is one of the arguments that Lebanese merchants put forward against industry's attempts to increase protective tariffs.

2. The issue came up lately when the Government was considering whether to license the building of a third cement factory. The license was granted but on condition that the new factory exports the largest part of its production.

3. As opposed to consumer goods.

of such resources might go up or alternatively there might be a great pressure on the price to go up and this might be undesirable. In such circumstances central banking action on bank credit would become desirable. Traditional monetary policy would mean the curtailing of bank credit by Bank Rate changes - which it is hoped would affect other rates - reserves requirements changes with supporting open-market operations. The problem now is to consider how effective these measures can be in Lebanon.

At present there is not much scope for any of the above measures to work in Lebanon, for banks have rarely any recourse to the Central Bank for funds. The reasons are that on the one hand they are very liquid, and on the other hand the Marché Hors Banque is a formidable loophole, as the reserves of the banking sector can always be increased by funds imported from abroad by foreign banks.

However, as the new conditions appear, i.e., as banks start buying Government securities - whether Lebanese or foreign - in Beirut, and investment banks start granting the medium- and long-term credits which they can liquefy through the Caisse Nationale de Reescompte, banks in general will gradually become more and more dependent on the Central Bank of Lebanon for liquidity, for they will reduce their foreign investment, and moreover might reduce the liquid balances they keep with each other which constitute the basis of the Marché Hors Banque. However, before rediscounting, the commercial banks will draw on their deposits with the investment banks which might then either rediscount or appeal for more deposits from other banks holding shares in them. In this case the Marché Hors Banque is still important and works alongside the Central Bank. But the future importance of the market will depend to a large extent on the behaviour of the foreign banks which are very active in it. In this respect it is possible that they will invest the funds acquired in Lebanon in safe and marketable securities which should become available in Beirût, rather than continue to do what they are doing at the moment, which is to lend most of these funds to Lebanese banks for them to invest. Now the answer to whether they will still be willing to lend, and if necessary to import funds to lend, to Lebanese banks in temporary need of cash, has to be qualified. Whether they will continue to lend for such purposes funds acquired in Lebanon depends on the rate offered, which is a function of the supply and demand conditions in the money market, but which in turn would be affected by rates offered in the strengthened capital market, and expectations regarding their future. This would be a direct consequence of linking closely money and capital markets. As the market for securities develops, Bank Rate should gradually have more influence on other rates and this would influence inter-bank lending. Thus Bank Rate and expectations about its future movements would come into the decision whether to rediscount at the Central Bank or borrow from the banks.

Now, whether foreign banks will continue to import funds to lend to Lebanese banks to help them meet claims in Lebanese Pounds is doubtful. This is done at present because Lebanese banks do not hold enough paper that can be rediscounted.[1] But with the development of the capital market and the widening of the range of paper that can be rediscounted at the Central Bank, one would expect banks to make much more use of the rediscounting facilities and less use of foreign banks.

However, what is likely to continue is the import of funds by foreign banks to lend to Lebanese banks in temporary and sudden need for foreign currencies. It is possible that the rate the Lebanese bank would have to pay on such a loan would be lower than that which it gets on its investment in foreign currencies, or alternatively it may prefer to borrow from the foreign bank because selling its foreign currency securities may involve a capital loss.

Therefore, the importance of what has been for a long time the effective lender of last resort, namely the Marché Hors Banque, will gradually decline. But the decline will be very gradual and might

1. See Chapter II p. 82 and Chapter V p. 269

take years. Until then the banking sector will still be quite independent of the Central Bank for liquid funds and thus the traditional measures of control mentioned above are not likely to be effective.

It may be said here that if foreign banks were restricted from importing funds into the country, variable reserve requirements might be an effective means of control, since in that case, the reserves of the banking sector could not be expanded without recourse to the Central Bank. There are two objections to the adoption of such means. One is that at least in the initial stages - which is the period when it was said these measures would not work - it could not force banks to rediscount at the Central Bank because they do not hold the required paper. Therefore, by restricting foreign banks from importing funds, Lebanese banks would be deprived of their effective lender of last resort and this is a dangerous situation. Another objection is that legislating against the import of funds by foreign banks is tantamount to an interference in the free flow of capital in and out of the country and this should be avoided if the Lebanese capital market is to establish itself. Thus as long as foreign banks can import funds into Lebanon - and it is undesirable to interfere with the free flow of capital in the Lebanese context - changes in reserve requirements will not be effective in any form[1] as a means of control.

1. For details of their different forms see Goode and Thorn 'Variable Reserve Requirements Against Bank Deposits', <u>IMF Staff Papers</u>, April 1959, pp 9-45.

Moreover, there is a strong case for not using general means of control, i.e., means that affect indiscriminately all the sectors of the economy: bottlenecks may appear somewhere in the economy and it might be desirable to restrain credit to that part only leaving the rest unaffected. A typical example is this: supposing that it is desirable to check the expansion of credit to the industrial sector because it is expanding too rapidly, and general measures to restrict credit are taken. These are going to affect credit to the commercial sector, too, and in many instances could have undesirable effects. One of the by-products of such a credit squeeze would be to reduce certain types of invisible receipts, and more specifically re-exports and commissions from triangular trade.[1] As shown in Chapter III these receipts are very important in the balance of payments. Business lost that way is very difficult to get back, and the longer the interruption of existing connections the harder it is to resume them.[2]

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1. It might be said that triangular trade is transacted in foreign currencies only and that therefore a general credit squeeze on advances in Lebanese Pounds only could not affect it. But to expand a Lebanese industrialist has to import machinery which will have to be paid for in foreign currency. Since he can get an advance in foreign currency, such advances would have to be restricted too.

2. Britain experienced such difficulties following the Bank of England ruling that bank and other lending should not rise by more than 5%. As the City Editor of <u>The Times</u> reported on February 28th 1966: "The invisible exports now being lost ... may be relatively small, but in absolute terms they are not insignificant". In Britain the situation is somewhat different and more difficult to solve than in Lebanon because the domestic currency - sterling - is used in third country financing and this means originally an outflow of sterling which the authorities want to stop in addition to checking domestic demand. In Lebanon, foreign currencies and not Lebanese Pounds are used for such transactions as the Lebanese Pound is not an international currency. Therefore there is no outflow of Lebanese Pounds to stop.

Now, as general measures are not recommendable, a strong case can be made for particular measures, i.e., measures affecting particular sectors and leaving other sectors relatively unaffected. This calls for the adoption of selective credit controls which "are intended to encourage or discourage specific types of investment and expenditure by influencing the lending policy of banks and similar credit institutions".[1] This type of control should be relatively easy to enforce in the case of medium- and long-term credit to industry through the requirement of prior approval of credit by the publicly owned Caisse Nationale de Reescompte, and to agriculture where the Government-controlled NDB will grant the credits. As regards short-term credit, a Central Bank could instruct the commercial banks not to increase their advances to the sector in need of restraint by more than a given percentage. The monthly statements banks would submit to a Central Bank would show whether they are complying with its wishes or not. Finally, the control of capital issues is relatively easy to enforce too because any increase of capital in Lebanon needs Government approval.

Selective credit controls will not reduce the total volume of bank credit as is evidenced by the Indian experience,[2] for although they

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1. Patel, I.G., "Credit Controls in Underdeveloped Countries", IMF Staff Papers, September, 1954.

2. For details of how such controls failed to reduce bank credit in India, see S.N. Sen, "Selective Credit Controls", in Arthaniti, November 1958, pp. 40-61.

succeed in restraining expenditure in particular channels, they might cause an increase in investment in other directions. But this is just what is required in Lebanon. If after they have been in force for some time, it is still felt that total advances should be restricted, a generalisation of the method by which selective credit controls are made effective could be used: a Central Bank could instruct banks not to increase their total advances by more than a certain percentage, and monthly statements would provide the effective check. A direct advantage of this method is that it may make it easier for the State to raise money at times when restrictions on total advances have been imposed. It would not make it cheaper though, because the banks would still have the possibility of investing abroad, i.e., the State would still have to compete with foreign securities whether issued in Beirut or abroad. It would make it easier to the extent that banks may be reluctant to convert some of their Lebanese Pound holdings into foreign currencies and therefore would rather buy the Lebanese Government bonds.

The enforcement of the measures will have to come from direct contacts between the Central Bank and the banks. A rediscounting ceiling for certain types of loans could be imposed but could not really be effective as banks could always rediscount some other paper or import funds from abroad and go on lending to the sector to be discouraged. Therefore, the main measure of enforcement will have to be moral suasion, which is widely used for example by the Bank of Canada in its attempts to allocate capital between consumers and investors and among the investors themselves.[1] The great advantage of moral suasion in Lebanon is that it gives the highly independent-minded banks the feeling that they are contributing to the monetary policy of the country and that they are not being policed by the Central Bank.[2] Besides, it does stand a chance of working because whatever banks cannot invest in Lebanon they can invest abroad very easily.[3] The effectiveness of the measures taken can be checked in the monthly returns banks submit to the Central Bank.

Now it can be seen why in spite of a good past record[4] bank returns to a Central Bank will be necessary. The psychological effect that foreigners need to have confidence in the custodian of their funds is one reason already noted. Another one is that the new programme that will be launched by the State, the new credit facilities that

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1. For details see E.P. Neufeld, "The Bank of Canada's Approach to Central Banking", in Canadian Journal of Economics and Political Science, August 1958.

2. This system has been successfully adopted in French planning. The feeling of contributing to a policy makes it easier to abide by it and especially in countries where individualism is strong.

3. This is a definite advantage over variable reserves requirements from the point of view of the banks. The foreign investment of the banks would be a real residual and would act like a safety valve.

4. See Chapter II p. 109

will be made available to the private sector and the new investment opportunities that will be created, will bring about conditions in Lebanon where a discretionary intervention in the monetary system will be necessary. So it is with relation to the future that a Central Bank is necessary for Lebanon.

What remains to be considered is whether the BSL could not have undertaken the tasks of a Central Bank as described above, and finally whether the newly created Banque du Liban could do so.

CHAPTER IV APPENDIX

A Case for Lower Deposit Rates

At a future date it might become desirable to lower the interest rates paid on deposits in Lebanon. There is no reason why banks should not compete for deposits by offering to pay interest even on sight deposits. But offering high rates could have two consequences. One is that the quality of service given might suffer and the other is the possibility of forcing some banks to go for highly speculative but, if successful, very profitable investments.

The first consequence is easily illustrated by the French banking system. In 1925 French banks were offering 5 and 6% interest. In order to stop this the 'Union Syndicale des Banques', which was under the influence of the large credit institutions and the chief 'banques d'affaires', decided to fix credit interest rates and to introduce certain charges in the form of commissions.[1] The result was that all banks applied in fact the maximum rates so that there was no more competition from that side; competition was transferred to other fields: material conditions and standard of banking services, expectations of credit facilities, personal relationships, proximity of the bank.

1. For more details see Cauboue P, 'Competition Among Banks in France and the Fixing of Their Rates', in Banca Nazionale del Lavoro Quarterly Review, June 1955 Vol. VIII pp. 86-98.

The second consequence is more difficult to illustrate because no bank would give details about its speculative investments or dealings. But it is known that banks in Beirut have sometimes engaged themselves in highly speculative real estate projects hoping to make a large profit. Some of them resorted even to what is called "cheque-kiting".[1]

But how can deposit rates be lowered? The French experience can be of help in this context. Through the Union Syndicale des Banques and the Association Professionnelle des Banques, banks managed to transfer competition among banks from rates of interest to quality of service. This tendency was further reinforced by the Law of 1941 and its 1945 Amendment. In Lebanon the Association des Banques du Liban described in Chapter II could similarly initiate such cuts in the interest rates and to enforce them it could ask its members to charge its non-members, or those banks which do not comply with its recommendations, customers' rates rather than interbank lending rates - which are lower. This would be an effective means of enforcement as banks rely considerably on the Marché Hors Banque for the provision of

1. Cheque-kiting is the practice whereby a bank draws a cheque on a foreign bank where it actually has no account, and then cables the money needed to cover the cheque when it expects it to come up for payment at the foreign bank (usually 5 days to give the cheque time to go through the clearing process and the post). The cabled money may be drawn on another foreign bank where again no account is held and which receives the money four or five days later, and so on. Cheque-kiting increases fictitiously the funds of a bank but is a dangerous practice as a miscalculation can cause a cheque to bounce with considerable damage to the prestige of the bank.

funds when in temporary need for cash, and it would be preferable to have such an action initiated by the banks through their own Association rather than by the Central Bank - their watchdog.

If deposit rates were lowered one could expect the banks to increase the range and improve the quality of the services they offer. Moreover one would also expect them to refrain from highly speculative investments. This should make the banking system more appealing and would improve the chances of Beirut becoming a financial centre.

POSTSCRIPT

Since this thesis was written there have been new developments concerning the B.C.A.I.F. A Development Bank is to be created to which the State, banks and the World Bank will contribute capital. It is to take over the business of the B.C.A.I.F. relating to industry and tourism. The B.C.A.I.F. will be renamed B.C.A.F.[1] and will be allowed to extend medium-term credits to salaried people wanting to buy a house.

Two things are worth noting in this context. One is that the World Bank with considerable experience and funds has got a 20% interest in the new Development Bank and one can then hope for an improved performance. The second is that the industrial business has been separated from the agricultural one. That was one of the suggestions we put forward.

However it involves only one institution granting medium-term credits to industry, in which banks have only an interest but not large enough to induce them to contribute as much money as they would if their stake had been larger. It will not be easy to ask banks to repatriate funds from abroad to invest them in an institution in which they have a small interest. Furthermore, the other activities that we suggested for the

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1. Banque du Credit Agricole et Foncier.

investment banks, viz. new issues, obligations for other countries, cannot be performed by this Development Bank.

CHAPTER V

THE BANQUE DE SYRIE ET DU LIBAN AND THE BANQUE DU LIBAN

The usefulness of a Central Bank in Lebanon was clearly demonstrated in the preceding chapter when we discussed the role that such an institution could play in the future. What remains to be considered now is whether or not:

1. The Banque de Syrie et du Liban - in short the BSL - could have efficiently taken the place of a Central Bank. This has to be considered since one of the problems posed in the first chapter was whether there was a need for a change of institution.

2. The Bank of Lebanon - the newly established Central Bank - will be able, under its present charter, to fill the role suggested.

I. The Banque de Syrie et du Liban

The BSL was a privately-owned French institution, established after the First World War in 1919 to take over the functions of the Ottoman Bank which until then had had the privilege of note issue in the Lebanon. The 1924 Charter granted the BSL the privilege of note issue for fifteen years with the possibility of renewal. The Charter was subsequently amended in 1937 and renewed for 25 years in 1939. It expired on 31st March 1964 and was not renewed. On the 1st April 1964 the Banque du Liban took over the privilege of note issue.

In April 1964 the BSL became a holding company,[1] its main assets being a large building in the centre of Beirut and half the share capital of the Société Nouvelle de la Banque de Syrie et du Liban.[2] The new BSL, which is a Lebanese commercial bank, took over the commercial business of the old BSL. We shall first describe the different activities of the BSL. Then we shall appraise it in relation to what it was supposed to do and finally we shall consider whether it could have fulfilled the role of a Central Bank in the economic development of Lebanon.

1. Activities of the BSL

a. Bank of Issue

The 1924 Statute, which was to last for fifteen years separated the Issue Department of the bank from its Banking Department. The BSL was to be the only note-issuing Bank for both Lebanon and Syria. The currency issued was known as the Lebano-Syrian Pound and was divisible into 100 Piastres; the rate of exchange was fixed at 20 French Francs to the Pound.

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1. 90% of the shares are now owned by the Banque de Paris et des Pays Bas.
2. The other half is owned by the Ottoman Bank.

Total note circulation was limited to a maximum of 25 million pounds, and was to be backed by a minimum of 45% in gold or foreign government securities payable in gold, the balance being in short terms bonds issued by the French government and commercial bills.

In separating the Issue Department from the Banking Department, the 1924 Statute was similar to the Bank Charter Act of 1844 in the United Kingdom, which had separated these two Departments of the Bank of England. However, the 1844 Bank Charter Act put a £14m. legal limit on the fiduciary issue, leaving the gold covered note issue to vary with the influx and efflux of bullion. Thus an influx of gold would be accompanied by an equal increase of the note issue, and vice versa. To the extent that an influx of gold meant increased economic activity and a greater demand for notes, the increase in note issue was welcome. There was no limit on the <u>total</u> amount of note issue.

In Lebanon, an upper limit was set not only on the fiduciary issue[1] but also on the total note issue. This meant that an increased demand for notes could only be met - if the issue had already reached £L 25m. - by an increase in the velocity of cir-

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1. As the minimum gold cover was to be 45% of the note issue the fiduciary issue could not exceed 13,750,000 pounds.

culation, even if the state of the reserves warranted an increase in the note issue. Clearly this resulted in an extreme rigidity in the note issue, which could not be justified even by the Currency Principle. This principle had laid down that "the quantity of notes and coin in circulation should never differ from the amount of money which would circulate if all the money were metallic."[1] There is no obvious reason for this extreme rigidity. One could only guess that it was caused by the fear of the BSL going wild, irresponsibly over-issuing notes.[2]

Two years before this convention was to expire, it was amended. Thus in 1937 the Lebanese Government and the BSL signed an agreement basically similar to that of 1924, but separating the Lebanese currency from the Syrian currency and altering the composition of the reserves. The maximum of 25m. pounds set for the note issue was abolished. A 50% minimum gold cover was now required, the balance being in commercial bills and government bonds. Thus the note issue could be varied within the limit set by the state of the economy and the reserves.

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1. Feavearyear, Sir A., The Pound Sterling, 2nd Ed. Revised by E. Victor Morgan, Oxford, Clarendon Press, 1963, p. 272.

2. It is the same kind of fear that made it necessary to put a restriction on the amount of public securities that the new Bank of Lebanon can keep in its portfolio. In this case it is the fear of an over-issue of securities by the State, and an irresponsible and abusive use of them.

The new convention which was to take effect in 1939 and to last for 25 years, maintained the Lebanese Pound on the French Franc Standard. Apart from a minimum 10% gold cover, the reserves were to be mainly in French Francs, French Government bonds, or deposits with the French Treasury. This put Lebanon, an under-developed nation, in the position of being a creditor to France, a developed nation.

The close link with the Franc also had the disadvantage of depreciating the value of the Lebanese Pound with each depreciation or devaluation of the Franc. Between March 1919 and the end of 1926 and with one exception in 1924, the Franc was on an uncontrolled floating standard, and was depreciating in terms of the dollar.[1] The effect on the Lebanese Pound was described by Mr. Yaffi:

> "Since 1920, the French Franc had depreciated from an exchange value of 2 cents to about 0.9 cent in May 1940 and coincidentally the Lebanese Pound lost - about 70% of its value."[2]

After the war, a severance of the close monetary links between France and Lebanon was felt necessary and a new Monetary Law

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1. League of Nations, International Currency Experience, 1944, p. 117

2. Yaffi, T. 'A Case for Banking Reform in Lebanon', Middle East Economic Papers, 1958.

came into being, altering the 1937 Convention. Thus the 1949 Law asked the BSL to maintain a note cover of at least 50% in gold and foreign currencies readily convertible into gold, the balance being in Government bonds, securities and commercial bills.[1] This took the Lebanese currency off the unstable French Franc Standard.

In 1949, the BSL started buying a considerable amount of gold, raising the gold proportion in the note cover from under 2% to 92.2% by December 1961. This was made possible by a favourable balance of payments. The balance of the note cover consists of government bonds and advances guaranteed by the Lebanese Government.

A reason given for a high gold ratio in the note cover is its psychological effect. This point was widely stressed by officials of the Lebanese Government responsible for that side of monetary policy. The high gold ratio helped considerably in maintaining and enhancing confidence in the Lebanese Pound. It is not immediately apparent why such a high gold proportion - 92% - was needed for this. But it is not untrue that it did help. To understand this, one has to remember that Lebanon is a country in the Middle East, where until recently, gold was to a great

1. However, it was also stipulated that commercial bills held as note cover were not to exceed 15% of the total note circulation.

extent still used as an internal medium of exchange. Furthermore, Lebanon is one of the most stable countries in the Middle East, and with a well developed banking sector is a good haven for capital. The fact that the Lebanese Pound was backed by gold to an extent of over 90%, had certainly some effect on the minds of capitalists still used to trading in gold. This was welcome since the large inflow of capital made possible a sustained trade deficit.

The Government and the BSL were to share the earnings of the note cover. But as the proportion of non-earning assets rose in the note cover, the Government relinquished this right, all earnings thus accruing to the BSL.

b. Government Bank.

The BSL was the main custodian of the Government funds under both the 1924 and 1937 Conventions. It paid interest on Government deposits, but its rates followed those of the Banque de France. Demand deposits received a rate of interest equal to the discount rate of the Banque de France minus 2%, and time deposits received that rate minus 1½%. In general, the rates paid were lower than those obtainable at other local banks, and this has been the subject of much criticism. But criticism on these lines is not totally justified. There is no one higher rate paid by all banks to all depositors, but a range of rates varying from one bank to another, and from one depositor to another. The interest paid is often the result of an agreement between the bank manager and the depositor. The Government could have done the same and re-negotiated the agreement with the BSL had it felt the rate was too low.

On the other hand, the BSL granted loans to the municipalities, the post office and semi-public institutions when other alternatives had proved either dry or too onerous. The rates charged then varied between 2½% and 4%, and so were substantially lower than those charged by other local banks. Thus the BSL might have offered lower rates of interest on public deposits, nevertheless it charged lower rates when the public sector asked for advances.

Beside making payments for the Government, the BSL was also the custodian of the Government subscriptions to international monetary organisations. It was also supposed to manage the public debt, but the very little there was of it was subscribed completely by the BSL itself. All these services were rendered free of charge.

The BSL was entrusted with the carrying out of decisions made by the Exchange Equalisation Fund. This Fund, created by Decree No. 8 of October 1949, was to be administered by a committee composed of the Minister of Finance, the Director General at the Ministry of Finance, the Controller General of Exchange, the Director of the Issue Department of the BSL and an official appointed by the Minister of Finance. The Minister presided over the Committee. The E.E.F., though constituted in 1949, did not actually intervene in the market until 1953, when the BSL was asked to buy United States dollars in the free exchange market. This move was intended to prevent the dollar rate from falling below £L 3.20.[1] But the E.E.F. never enjoyed great importance and when it acted it was merely

> '.... because of the pressure of impending economic circumstances, rather than a reflection of a pre-determined policy'.[2]

6. <u>Bankers' Bank</u>

The BSL performed this role in two ways:

a) by relieving the banks of temporary liquidity shortages, and

b) by allowing the banks to keep balances with it for clearing

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1. The dollar rate had risen considerably (to £L 3.87) following the outbreak of the Korean War. It fell drastically when the hostilities ended, causing considerable damage to the mercantile sector of the economy.

2. Saba, E.S., The Foreign Exchange Systems of Lebanon and Syria 1939-1957, American University of Beirut, Beirut, 1962, p. 122.

purposes.

a) The BSL helped the banks in need of liquid funds by rediscounting their paper, by providing them with lines of credit or by lending them 'en pension'.

i) Rediscounting

To be eligible for rediscounting a bill had to carry three signatures, and its life to maturity was not to exceed 120 days, if held in the Banking Department, and 90 days if held in the Issue Department. The rediscount rate followed that of the Banque de France until about 1953, and since then has been fixed at 3%

ii) Overdraft Facilities

The BSL opened lines of credit to commercial banks. This consisted in giving the banks non-secured open credits up to certain amounts. Repayment, which was determined by contract, was usually extended up to one year, but with an understanding that the loan could be revoked with a forty-five days notice.

iii) Borrowing 'en pension'

This system was developed to relieve banks of minor and very short term liquidity crises, and to minimise losses.

The BSL would buy bills from the bank in need of cash, on the understanding that the said bank would repurchase them seven days later.[1] This system was very practical, and bankers have said privately that they made a considerable use of it. The rate of interest charged on such borrowing was $3\frac{1}{2}\%$.

b) Beside managing the clearing office, where all banks sent two representatives, and keeping deposits for banks for clearing purposes, the BSL administered the Centrale des Risques.[2] This office was started under the auspices of the Government in 1953, and was designed to protect the banks from unworthy borrowers, thus increasing the safety of the banking sector. Member banks who pay for its running are required to submit to the Centrale regular information about the loan facilities of over £L 25,000 granted to their customers, and the extent to which they have been used. The information thus compiled by name of borrower is then distributed to member banks and this helps them in assessing the credit worthiness of borrowers. No great

1. Seven days was the usual period but it could vary.

2. The Centrale is now administered by the new Central Bank, the Bank of Lebanon.

use could be made of the Centrale until 1962, as many local banks refused to join it. However, in that year, membership of the Centrale was made compulsory, and in interviews bankers have said that this body is highly valuable and that great use is made of it.

D. Commercial Bank

As explained earlier, the Banking Department and the Issue Department of the BSL were separated in 1924. The two departments remained two distinct entities until the establishment in 1964 of the Bank of Lebanon, which took over the privilege of note issue in Lebanon.[1] It is difficult to assess the magnitude of private deposits and advances that the BSL commanded in the Lebanon, as it published only combined balance sheets for both Lebanon and Syria. Furthermore, the statements never gave separate figures for the public sector the private sector and the banks. All those sectors appeared under one figure.

It is reported that in the early 1950's the BSL commanded about half the total private deposits in the Lebanon, and that it was responsible for about 70% of total advances and discounts.[2]

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1. The BSL stopped issuing the Syrian currency in 1956 when the Central Bank of Syria was created.

2. Yaffi, T., op. cit., p. 104.

By the late fifties, the situation had changed. the BSL share of private deposits and advances fell throughout that period mostly because of the establishment of new banks in Beirut. It is believed that the BSL held only about 10% to 15% of private deposits in Lebanon when it ceased its activities in March, 1964. As regards advances and discounts, the proportion had fallen too, though not to the same extent.[1] Unfortunately, no exact figures are available.

The BSL's activities in commercial banking were regulated by its statutes. It was allowed to extend short term credits, and to discount commercial paper, provided the paper satisfied the requirements laid down. It was not officially allowed to grant credit against mortgages, but it is believed that it did not abide strictly by this rule.

In general the Banking Department of the BSL acted like any other commercial bank in Lebanon, but with the difference that it held the meagre supply of Lebanese Government bonds. Other banks did not have any of them.

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1. Ibid, p. 105.

2. Appraisal of the BSL with reference to what it was supposed to do.

It has been common to appraise the BSL with reference to the traditional functions of central banks.[1] This approach is misleading for two reasons, one general and one particular. The general reason can be found in the first chapter: to approach the problem of central banking in developing countries in terms of the traditional functions of Central Banks is inappropriate and misleading. One should look at the problem in the economic context in which the central banks operate. The particular reason why this approach is misleading is the fact that the BSL was not intended to be a central bank. It was created after the First World War to take over the privilege of note issue from the Ottoman Bank, and it was not to be more than a bank of issue. It had no powers of control over other banks, and had no special responsibilities for implementing a monetary policy. The 1937 amendments did not alter this position. But with time it came to perform certain central banking activities that fell to it by reason of the circumstances and conditions in which the Lebanese banking sector was working. These activities were described in the previous section.

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1. Ibid., Toak, J.W.J., Monetary and Banking Developments in Lebanon, M.Sc. (Econ) thesis at the London School of Economics, 1960. Typescript. Mahmassani, Y.A., A Central Bank for Lebanon, M.A. thesis submitted at the American University of Beirut, Feghali Press, Beirut, 1961.

So to appraise the BSL as essentially a central bank expected to behave like one, is wrong. It is as a bank of issue that it should be appraised. So we shall start with this aspect, then we shall appraise the BSL's 'central banking' activities, and finally its commercial banking.

A. Bank of Issue

In this context there are two points. One is whether the private and foreign ownership of the BSL was in any way detrimental to the Lebanese economy. The second is whether the BSL provided some elasticity to the note issue.

There is no reason to believe that the foreign and private ownership of the BSL was in any way detrimental to the economy, at least on economic grounds.[1] The BSL was based in Paris but did very little commercial business in France. Even supposing that it did carry out such business, it would not have made much difference, for the BSL had no access to confidential information that could

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1. The private and foreign ownership of the BSL was often criticized on political grounds. That was done in identical terms by Yaffi, T. op. cit., pp. 111-112, Toak J.W.J., op. cit., p. 157. Mahmassani, Y.A., op. cit., pp 68-83. The same criticism was raised against the BSL in Syria where it was also the note-issuing bank. For this see Ashshy, G., The Syrian Monetary System (in Arabic) 3rd ed. Damascus 1959, p. 150; also 'The Reasons for the Promulgation of the Basic Monetary System and the Establishment of the Syrian Central Bank' which appeared in The Basic Monetary System (in Arabic) March 1953 pp. 84-85. Quotations on pp. 16 above.

be of any benefit to foreigners. Regarding its private ownership, there is no reason to believe that if it had been publicly owned it would have been better run:

a) it was not a Central Bank and therefore its responsibilities towards the economy were quite limited. There was no monetary policy to implement because the Government never had one, and even if it had had one the BSL had no powers of enforcement.

b) its already limited activities were concentrated in its Issuing Department which on the one hand was subject to conditions laid down in its statutes, and on the other hand was under the constant supervision of the Government.

Now, with regards to note issuing proper, the BSL, in the period considered - 1950-1964 - did provide the Lebanese currency with the elasticity needed to maintain stability. Table XXV[1] shows the growth of the currency issue in Lebanon between 1950 and 1964. The average rate of increase was 11.7% a year, but it was by no means regular. The currency issue responded to economic factors which in turn were sometimes influenced by political factors. Looking over the figures for 1958 for example, the issue moved from £L 356 millions in the first quarter to £L 424 millions in the third quarter,

1. Identical to Table X in Chapter II.

thus increasing at a yearly rate of 38%, when the average annual rate for the whole period was 11.7%. The reason for this sudden big rate of increase was the political crisis of that year which brought the economy to a standstill for six months. A large demand for cash followed, as explained in the Appendix to Chapter II.

When the situation was normal again the amount currency issued fell back to £L 399 millions in the fourth quarter of 1958, and £L 394 millions in the first quarter of 1959. It is worth noting that the level it fell back to, in the first quarter of 1959, represents a 10.7% rate of increase over a year before. This rate is 1% less than the average annual rate for the whole period 1950-1964, and this is a clear example of the elasticity the BSL gave to its note issue, and of its attempts to avoid grave crises of confidence.[1]

Therefore, as a bank of issue and with reference to what it was supposed to do, the BSL was fulfilling its role adequately and any decision to end its Charter or not to renew it when it expired

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1. It is important to stress here the influence of political factors in the economy and the need to avoid crises of confidence in the liquidity and solvency of the banking sector, for it strengthens the point made in the last chapter that the rediscounting facilities should be looked at as an insurance against such crises rather than as something that will be used all the time.

T A B L E XXV

CURRENCY ISSUE IN LEBANON (L.L. Million)

Year	Quarters			
	I	II	III	IV
1950	→	196	←	
1951	→	208	←	
1952	→	200	←	
1953	→	199	←	
1954	→	223	←	
1955	243	252	264	266
1956	270	282	300	333
1957	328	342	347	356
1958	356	407	424	399
1959	394	394	397	400
1960	400	416	427	431
1961	431	431	431	437
1962	437	442	455	470
1963	470	485	493	505
1964	522			

Figures for 1950-54 are yearly averages.

Source: BSL, *Rapports*.

should really have been taken after an analysis of the future role that the BSL would have been called upon to play. But before doing that the various 'Central Banking' activities that fell to the BSL by reason of the circumstances and conditions in which the Lebanese banking sector was working, should be considered.

B. 'Central Banking' activities of the BSL

These activities centred round the BSL ad a bankers' bank. This should be understood in the literal sense of the phrase, i.e., the BSL was literally the bank of the other banks, rediscounting their first class paper, granting them loans and allowing them to keep deposits with it for clearing purposes. It did not try, nor was it expected to, control the banking sector through the role of a bankers' bank.

The discharge of its functions as a lender of last resort has been criticized[1] for it was noticed that banks in general did not make much use of the rediscounting facilities offered by the BSL and it is said that the bulk of the rediscounting was made

> 'to the French owned or French controlled banks or to the small banks and discount houses'.[2]

It is said that banks in general did not rediscount because they

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1. See footnote 1, p.263
2. Yaffi, T., op. cit, p. 105. Toak, J.W.J., op. cit. p. 122.

they were never sure of the rediscount rate that the BSL would charge, and also because the BSL was privately owned, and therefore to borrow from it would be a loss of face. The first reason is wrong because the rediscount rate was fixed at 3% in 1953 and has not changed since. As to the second, it is not valid either as is evidenced by the considerable use made of the 'en pension' method of borrowing, and the great activity of the Marché Hors Banque where equally strong competitors operate. Therefore the reason for the absence of much rediscounting should be sought elsewhere.

Banks were unable to make full use of the rediscounting facilities at the BSL because of the nature of their assets. The BSL could rediscount paper bearing three known signatures, and with a maximum life of ninety days if held in the Issue Department, and one hundred and twenty days if held in the Banking Department. The banks did not hold enough of such commercial paper; the proportion of trade bills to total money available or lent was very low.[1] Lebanese banks held a great deal of what is called accommodation paper. It bore usually two known signatures, but when it fell due it was often renewed. It was a form of medium term credit that the banks were willing to extend. The BSL was reluctant to rediscount such paper, as

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1. There were no Treasury Bills and no short dated Government securities in Lebanon. Also see Chapter II, p. 82 for falling ratio of bills to total money lent.

its life was in fact longer than the maximum life allowed by its statutes. On the other hand Lebanese banks held a great deal of assets in the form of unsecured advances and loans against mortgages or stocks. They also accepted and discounted hire purchase bills. All these assets could not be rediscounted at the BSL for in this respect it was restricted in much the same way as are central banks. Therefore an alternative lender of last resort had to be found[1] and this is why the Marché Hors Banque which, as we showed in Chapter II could act like a lender of last resort, became so important, in spite of the higher rates that had to be paid in it. Thus, if banks did not make much use of the rediscounting facilities at the BSL it was because they could not satisfy the requirements which were set by the Government for rediscounting. To deviate from its bye-laws, the BSL had to have the authority of the Government, and this was done on three occasions, in 1956, 1958 and 1964.[2]

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1. It has been suggested, that banks kept wastefully high cash ratios because they did not want to rediscount. This is not true as can easily be seen in Chapter II.

2. 1956 was the Suez war year. The hostilities brought about fears that English and French banks might be asked to cease their activities in the Lebanon and that their deposits might be frozen. Substantial amounts of money were transferred from these banks to local ones within three days. English banks received some help from their head offices but had to ask local banks to provide them with additional credit. French banks suffered more severely as their head offices were unwilling to commit more funds in the circumstances. Local Lebanese banks rescued them.
In 1958, the same thing happened but in the other direction. Depositors feared that local banks would be unable to withstand the heavy strain of the political upheaval of that year and transferred their deposits to foreign banks. This time, it was the turn of foreign banks to help their Lebanese colleagues.
In 1964 a Lebanese bank was declared bankrupt. A slight crisis of confidence ensued and the reserves of certain Labanese banks dwindled to dangerously low levels. Foreign bankers helped those which were solvent but faced an unusual run of their deposits.
No figures are available in support of what has been said about the 3 crises. All this information was compiled from private interviews with bankers.

The reason why it was felt necessary that the BSL should deviate from its statute springs from practical considerations. In effect one could argue that in emergencies the MHB would help only if foreign banks were confident as to the outcome of the crisis. One would then suppose that if they were not confident they would be reluctant to invest money in the country. Their combined <u>inaction</u> could deprive Lebanese banks of one of their main sources of funds, and were this to happen, a situation analogous to that in the United States in 1907 would occur, for, with no other intervention, the supply of money to meet the sudden demand for it would be limited to the reserves of the banks. Son on the three occasions mentioned above the Government instructed the BSL to rediscount freely - i.e. with less regard to its bye-laws, - and guaranteed the operations with the public deposits held at the BSL. It was a sort of stand-by arrangement or, using an expression from the preceding chapter, a sort of insurance against the risk of withdrawal of funds outstripping the available supply or reserves. This confirms further the point made in the previous chapter, namely that the Central Bank's rediscounting facilities will be more a kind of insurance to the stability of the banking sector than a source of permanent finance.

What all this shows is that when the authority that imposed restrictions on the rediscounting facilities of the BSL relaxed them, it could act like a lender of last resort. What it also shows is that if in normal times and even in emergencies, banks did not make much use or as much use as expected, of these rediscounting facilities it was, to repeat, only because banks could not meet the conditions set by another authority than the BSL - the Government - and had found an alternative source of funds - the MHB. This we hope proves two points:-

a. that the cause of the lack of rediscounting was not that the BSL was privately instead of state-owned;

b. that the need of a lender of last resort was not relevant to the decision whether or not to endow Lebanon with a state-owned Central Bank - or alternatively whether or not to renew the BSL charter. This used to be one of the chief arguments for a state-owned Central Bank. It was alleged that not only would it be convenient for the banks to have a lender of last resort but it would also make possible the implementation of a monetary policy.[1] In March 1964 there was no need for

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1. Yaffi, T. op.cit. p. 110. Toak, J. W. J. op.cit. p. 148, 149. Mahmassani, Y. op.cit. Chap. IV Section IV.

a conventional lender of last resort. The importance of this point is great. For it means that the mere provision of a state-owned Central Bank could not be expected to cause the banks fully to use the rediscounting facilities offered, thus making a traditional monetary policy possible. The case for a state-owned Central Bank lay elsewhere.

Therefore, here again, in relation to what it was supposed to do and what it could do, there was no justification for criticising the BSL, and if the conditions prevalent in the period 1950-1964 were to continue into the future there is so far no reason on economic grounds why the BSL's privilege of note-issue in the Lebanon should not have been renewed.

C. <u>Commercial Banking of the BSL</u>

There are two points to consider in relation to the commercial banking activities of the BSL:

(1) whether its activities contributed to the economic development of the country; and

(2) whether as a bank of issue it should have conducted commercial activities.

As regards the first point, it may well be that the BSL's commercial activities did contribute to the economic development of the country. As recently as the early 1950's, the BSL was still responsible for about 70% of total advances and discounts in the country.[1] To have deprived it of its commercial business on the grounds that a bank of issue should not compete with other banks would probably have been a setback to economic development. In effect the BSL was filling a gap in the economy, for although the banking sector was developing rapidly, this growth was taking place mainly in the nineteen-fifties, and the banks were still small and lacked the experience and expertise of the BSL; thus there was a case for it to retain its commercial activities. But as the decade passed, and many other banks opened up and started commercial business, the BSL's share of total advances and discount fell. So, in 1964, the gap the BSL was filling was not as wide as in the fifties and one could then question the desirability of associating note-issue with commercial business after 1964.

If conditions were not to change, and if the BSL was to have its privilege of note-issue renewed, a case dould be made for it

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1. Yaffi, T. op.cit. p. 105.

to retain its commercial activities. One the one hand, the conflict between the private and public interests that may arise in this context because the bank is privately owned, may arise even if it is state-owned. State-owned Central Banks in general are no more insensitive to the attractions of sound and profitable loans than their commercial colleagues: 'In some instances the banking department [of a Central Bank] has been a leading contributor to an excessive expansion of credit'.[1] On the other hand, this aspect of its work was beneficial in one important respect in spite of its falling share in that business: it was the only reliable means by which the BSL could keep in constant touch with the market. This is essential if the appropriate measures that are the responsibility of the Issuing Bank are to be taken.[2] "On the whole the evidence warns us to be cautious in developing the ordinary banking business of a Central Bank, rather than to say that there should be no such business."[3]

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1. Goode and Thorn, 'Variable Reserve Requirements against Bank Deposits' I.M.F. Staff Papers, April 1959.

2. It has been reported recently in financial papers that the Bank of England itself is thinking of reviving its commercial banking activities to influence the policies of the joint stock banks. It must have been felt that in spite of intensive rediscounting practices and many other devices of control and checking, which the BSL does not share, a closer and more direct touch with the money market was necessary to provide the joint-stock banks with a lead.

3. Sayers, R. S. 'The Central Bank as a Banker' 2nd of three Lectures Central Banking in Under-developed Countries, delivered on the 50th Anniversary of the National Bank of Egypt in April 1956 in Cairo.

In conclusion, we could say that the BSL was fulfilling its purpose adequately and properly. If conditions were not to change in the country and thus no new functions were envisaged for the BSL there was no reason on economic grounds why its charter should not have been renewed when it expired in 1964.

3. THE BSL AND THE POST 1964 CONDITIONS

In Chapters III and IV the changing conditions of the Lebanese economy and the role that a Central Bank could play to promote the economic development of the country were discussed. A Central Bank is needed in the new context and this implies immediately that the BSL - essentially an issuing bank - was not adequate for the future as it stood. Two lines of action were then open.

1. either to make the BSL into a Central Bank and therefore radically change its charter; or
2. to create a new state-owned Central Bank with powers adequate to deal with the future economic conditions of the country.

Therefore, whatever line of action was adopted a new charter had to be adopted and the problem of whether the BSL should be the new Central Bank or not becomes basically whether the new Central Bank should be state-owned or not.

The strongest argument for a privately owned Central Bank in Lebanon is perhaps the general distrust of any publicly owned or publicly controlled institution. The argument is not an economic one but can have economic consequences. These relate mainly to the relations the Central Bank will have with the State. The distrust leads to a constant fear of collusion between the State and the Bank, i.e. the fear that the Government in power might use the Bank to further political objectives without regard to economic objectives. However close the contacts are between the Government and a privately-owned Central Bank, it is likely that it would offer more resistance to political interference than would a state-owned bank.[1] Therefore, if a state-owned Central Bank was to be adopted stiff measures would have to be taken to ensure that the Government could not sacrifice economic objectives for political ones, and this means tying the hands of the Bank in so far as Government finance is concerned, as indeed happened in Lebanon in April 1964.[2]

But the case for a state-owned Central Bank is very strong, because of the future role it could be called upon to play. The case is strong with respect to:-

a. The local capital market.

As discussed in Chapter IV a main task of the Central Bank is to bridge the gap that exists between the short-end of the

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1. It has been said (Yaffi, T., op.cit. p.112) that an advantage of making the BSL a Central Bank was the continuity of service, which would be provided by the same personnel. This however is no strong argument because those responsible for the note issue at the BSL could be taken by the new Central Bank.

2. See Chapter I, pp. 35-36 and below p. 290

market for funds, which at the prevailing interest rates has excess supplies, and the long-end of the market where there is unsatisfied demand. This implies the powers to rediscount medium-term bills, to give directives to the Caisse Nationale de Reescompte, to help the NDB in its debenture issues, and probably support their prices, to help the state finance its programme, and to time everything in the best interests of the economy, i.e. to allocate the funds available in the most efficient way. This role is best achieved by a governmental institution for the risks involved in what amounts to 'underwriting the economic development'[1] of the country are too large either to be acceptable to a private institution or given to a private institution.

b. The international capital market.

In this context the Central Bank will have to offer expert advice to investment banks, full guarantees to lenders, and create a favourable climate for such a market by working in concert with and advising the Government. In Lebanon a state-owned institution

1. Expression borrowed from Nevin, E., Capital Funds in Underdeveloped Countries: The Role of Financial Institutions, MacMillan & Co. Ltd., London, 1961, p. 89.

is eminently better placed to carry out such functions because a privately owned institution might still be looked upon with suspicion.

c. The future economic conditions

The evolution of the Lebanese economy and of the banking business in general will bring about new economic conditions where central bank action regarding the banks might be necessary. In Lebanon much such action might have to rest on personal contacts between officials of the Central Bank and bankers. "Moral suasion" would be required and it would obviously be much more effective if the Central Banker was not just another banker with certain privileges, but a state-owned institution with the full authority of the State behind it. This is important if commercial banks are both to co-operate with the Central Bank in formulating a policy and to abide by it. Furthermore, a monthly control over the banks' balance sheets will be necessary. Bankers will be more willing to submit their monthly position if the Central Bank is not privately owned, lest information benefiting private individuals becomes known, nor a competitor in the field:[1] it is

1. Supporting evidence for this argument can be found in the earlier history of the Bank of England and the more recent history of the unsatisfactory relations between the Australian trading banks and the Commonwealth Bank.

easier to submit a balance sheet to a non-competitor than to a competitor. Thus, although for other reasons it might be desirable to allow the Central Bank to compete with other banks in commercial business, such as to keep in touch with the market, it would be preferable if it was not allowed to, at least initially, and one can hardly ask a privately-owned Central Bank to stop commercial business overnight - as would have happened if the BSL had become the Central Bank.

Therefore, in spite of the risk of political interference in the monetary affairs of the country, there is a good case for the Central Bank to be state-owned rather than privately-owned. The risk of political interference can be diminished by providing the Central Bank with some independence from the Government, and especially with a strong Governor. This is partly why it is desirable that commercial banks should be consulted on matters of monetary policy: by doing so the private sector could help to counter-balance political interference from the public sector.

Summing up, a State-owned Central Bank with no ordinary commercial business is therefore what was needed to replace the BSL when its charter expired on the 31st March, 1964 - a Bank that could keep in close touch with the money market and the different economic sectors, for a Central Banking system should always be appraising major developments affecting the whole economy. As a President of the Federal Reserve Bank of New York said:

> 'Central Banking is a public service which requires of its practitioners continuous contact with economic processes, and with people in the market places of the country as well as with the representatives of Government at its centre'.[1]

Lebanon did get a State-owned Central Bank in April 1964 and this ended the reign of the BSL. But will this Bank, described in Chapter I, be able to fulfil the role that will fall to it, or in other words, is the Banque of Lebanon a well-adapted Central Bank. It is to this question that we finally turn.

II THE BANK OF LEBANON

This section will be dealing with the newly created Bank of Lebanon (or BL) which was described in Chapter I. In particular, we shall appraise the BK in relation to the future role it will be called upon to play if it is to help in financing the economic development of the Lebanon.

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1. Sproul, A. 'Reflections of a Central Banker'. Paper read at a joint meeting of the American Finance Association and American Economic Association, on 29th December, 1955, in New York City. Published in Journal of Finance, March 1956, Vol. XI. Mr. Sproul was the president of the Federal Reserve Bank of New York, the vice-chairman of the Federal Open Market Committee of the Federal Reserve System.

1. NATURE OF THE INSTITUTION

If the Central Bank is to be state-owned but still free from political interference, it requires a highly independent Board. The BL is owned by the State, for Article 15 of the 1963 Banking Legislation specifically states that the capital is provided entirely by the State, and that any future increase will also come from the State. Moreover, the principle of independence was accepted by the authorities:

> 'The nature of the Bank of Lebanon naturally created a problem of choice. Should the Central Bank be a purely State institution or an independent institution but subject to certain State controls? But the dangers that face monetary institutions with state administrations, and the desire to maintain her traditional liberalism, made Lebanon choose to give her Central Bank great independence.'[1]

But whether in practice the principle will still hold is not very certain, for it seems that it will all depend on the personalities involved. In effect the Governor is appointed by the Government and so are the three Deputy Governors. But their long terms of office - 6 and 5 years respectively - make it possible for them to be

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1. Takla, P. Governor of the Bank of Lebanon, extract from a speech delivered at the Rotary Club in Beirut on 25th May 1964. It was reported in <u>L'Orient</u> on 27th May. It was the first official speech of the Governor of the Bank. Translation from French is mine.

relatively free of interference from the Government of the day. Therefore, depending on the personalities of the Governor and the Deputy Governors, the Central Council, which decides on matters of monetary policy and whose membership includes the Director Generals of the Ministries of Finance and National Economy, could be prevented from politically interfering with the Bank's staff as the latter hold the majority of the seats. This should not be considered as an argument for excluding the Director Generals from the Council, for close contact and co-operation between the Bank and the Ministry of Planning, which in this case could be represented by the Ministry of National Economy, is necessary. On the other hand as Article 28 mentions, the two Government officials will not be acting as agents of the Government but simply as members of the Council in charge of monetary policy. But it must be realised that these two Directors are more liable to be pro-Government than not and that is why although close co-operation is needed between the Bank and the Government, the Governor and his Deputies should be independent and strong enough to distinguish between the truly worthwhile Government decisions and the short-term policies dictated by expediency. The mechanism for decision-making in the BL makes it possible for the Bank's top executives to work that way but there is no guarantee of it, and it might have been preferable to give more say in decision-making to non-governmental bodies. Banking, Commerce, Industry and Agriculture are already represented in the Consultative Committee which also includes a professor of economics, but they have no power, their role being merely advisory.

2. THE BL AND THE NON-BANK PRIVATE SECTOR

The essential role of the Central Bank in this context is to help divert some of the resources of the money market into the capital market. The ancillary role - which is also very important - is to create in Beirut conditions which will attract for investment in Lebanon funds from the rest of the Middle East seeking investment opportunities. We have described how this might be done. Will the BL be able to perform this role?

For these purposes the BL must be able to hold medium and long-term paper, for, whatever plan is adopted, no adequate and local medium or long-term credit will be available from the banks in Lebanon if there is no guarantee that in an emergency the paper can be liquified. As the Central Bank is the only final supplier of cash it alone can give that guarantee - or insurance - and if it cannot rediscount and hold medium and long-term paper, it cannot give this guarantee in which case banks will not accept such paper either. It is not a peculiarity of the proposal made in Chapter IV that makes it essential for the BL to be able to rediscount medium and long-term paper; any proposal to make use of the potentalities of the banking sector in Lebanon will require similar assurance. To ensure the availability of the medium and long-term credits that are needed in Lebanon, it is essential that:

1. banks should not be required to match their assets too closely with their liabilities. This is feasible in the Lebanon.
2. the Central Bank should provide the guarantees needed for the liquidity of the assets.

The new Law is quite elastic with respect to 1. In effect Article 156 states that the banks must adapt the lives of their investments to the characteristics of their resources. Now, if it is agreed that most of the resources of the banks are in fact medium-term resources - as we tried to show in earlier chapters - this provision of the law will not stand in the way of the provision of medium- and long-term credits.[1] But Article 156, though necessary, is not sufficient to ensure the provision of medium- and long-term credit because the BL should be able to guarantee the liquidity of the paper issued with such credits; but the BL does not provide such guarantees nor can it do so, by Law, as Article 100 of the Code de la Monnaie et du Crédit, which established the BL, forbids the Bank from discounting commercial industrial and agricultural bills with lives exceeding 90 days. Therefore, if the banks are to grant the medium- and long-term credits that are badly needed in the economy, they will have to do so at their own risk and without a guarantee of liquidity from the Central Bank - and for that matter without the control of the Central Bank. It could be said that in emergencies Article 100 could be relaxed or suspended, just as the BSL rediscounted more freely in 1956, 1958 and 1964. But this is a different context for the suspension of Article 100, unlike the BSL facilities, needs to be approved by Parliament and delays may be harmful. Furthermore, even if the Article can be suspended in time, the Central Bank might find

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1. If the first draft of the Law had been adopted, the problem would not have arisen in the same way, for it was intended that there should be two categories of banks: commercial banks specialising in short-term credits, and investment banks specialising in long-term credits. But this was not adopted because no criteria for making a distinction could be agreed upon by the Government and the Association des Banques du Liban. Article 156 was the compromise.

itself forced to rediscount long-term paper representing a credit which it would not have approved of had it been consulted before it was granted.

Thus, the BL as at present set up will not be able adequately to assist economic development. In particular, it will not be able to help the investment banks nor the NDB in the issue and marketing of debentures, nor to rediscount its medium-term paper if the need arose. Although the BL is empowered to assist the public sector - the NDB would be semi-public - in contracting a domestic loan, it is not allowed to buy or rediscount securities with more than three months to maturity; since the BL will not buy them in an emergency, these securities will not be easily marketable and therefore, both financial institutions and private individuals will be reluctant to buy them. Here again, the resources at the disposal of the banking sector which could be used to help the agricultural sector of the economy and tourism (through the construction of new hotels) will not be available for such uses.

Although rediscounting is not the only way by which the Central Bank can 'underwrite' the economic development of the country, it is essential because it provides a link between the Bank and the banks that must finance the development. The banks need that link to guarantee their liquidity, and the Central Bank can use that link to see that the funds go into worthwhile projects and do not create inflationary pressures in the economy.

Therefore, as it has been created, the BL can do nothing to help provide the Lebanese economy with the medium- and long-term credit it badly needs and which is widely realised. At present all the BL can do in this respect is to guarantee some loans which specialised institutions, such as the B.C.A.I.F., might need to replenish their resources. This is not a satisfactory arrangement and it is very similar to the one existing while the BSL was still the issuing bank, and which proved to be totally inadequate.

3. THE BL AND THE PUBLIC SECTOR

The question to consider next is whether the BL can help the State to finance the deficit it expects to have in providing the country with the infrastructural equipment it needs. Domestic borrowing is possible and is preferable to foreign borrowing or to an increase in taxation. But the active co-operation of the Central Bank is necessary, as only a Central Bank can guarantee the liquidity that is essential if the public issues are to be taken up.

Article 97 of the Code provides that the BL will assist the Government in raising loans and will act as this latter's agent. But while the usefulness of a National Debt is recognised and the BL is its manager, the scope for using it is limited by Articles 106 and 108. Article 106 limits to 3 months the life of the securities that the BL is allowed to buy or keep in its portfolios. Thus any issue of medium- or long-term obligations will lack that essential requisite to make it successful - a guarantee of marketability which can only be provided by the BL. As long as the Bank is not allowed to deal in this type of security there will not be a market for them and the State will not so easily get the type of credit it requires. In this respect the BL is again ill-adapted to assist in the development of the economy.

As regards the short-term loans or renewable Treasury Bills which the State could issue to get round Article 106, here again their marketability is heavily restricted. This time it is by Article 108 which stipulates that the BL cannot hold in its portfolio public securities in excess of its capital and its Reserve funds. Its capital is £L 15 million, and its Reserve funds were £L 1,560,000 in December 1964 - and therefore will be negligible for a few years to come. Thus, only about £L 16 million worth of public short-term bills are actually marketable enough to be accepted by investors. In view of the requirements of the public sector the amount is clearly negligible and thus here again, the BL can be of no help to the State.

One of the reasons lying behind these restrictions on the marketability of a National Debt is a distrust of the State. It was feared that the State might over-issue its securities to avoid increasing taxation. This fear may be well-founded but the Code provides the Bank with the powers to advise the Government on financial and fiscal matters (Article 92); and if a strong Board with non-governmental bodies well represented in its decisions runs the Bank, this fear should be reduced. On the other hand, the State is committed to carry out the projects already described; if it cannot raise the money locally it will have to raise it abroad and there is no guarantee that the State will not incur external debt to avoid an increase in taxation, even when the latter course is possible.

4. THE BL AND THE SERVICES SECTOR

The need for diversifying the services sector was brought out in Chapter III: as old services decline in importance new ones have to be created as this sector is extremely important in the balance of payments. It was also suggested that banking, finance and tourism could well be the services that could be developed in the future. How that might be done was discussed in Chapter IV and the proposals were that as far as tourism was concerned banks could provide the eighteen months credits required by the hotel industry while the NDB would provide the long-term credits needed for the construction of new hotels. As regards the development of banking and finance, the idea was to attract funds from the rest of the Middle East for investment in Lebanon either in Lebanese securities or in foreign ones, but issued by a Lebanese investment bank in Beirut. The development of the services sector was to be a consequence of the developments of the other sectors of the economy.

However, the proposals put forward implied specific responsibilities for a Central Bank and in this chapter it has been shown that the BL is not able to assume these responsibilities with regard to the industrial, agricultural and public sectors. Since it cannot assist in the creation and development of the investment banks, the NDB and hence a capital market, there is therefore again not much it can do to help the services sector.

It may be argued, however, that the fact that the balance sheets of the banks are now scrutinized by the BL will strengthen confidence in the Lebanese banking sector, and thus encourage people to deposit more money in the banks. This is a very narrow view. Although it is true that supervision of the banks may enhamce confidence in their solidity, it will do little to increase or even maintain the relative importance of the banking sector. As already explained, the holders of the funds are becoming increasingly sophisticated in their investment decisions, and eventually will no longer be content simply to keep accounts with banks in Beirut. They will be seeking more profitable and suitable investments, and if they cannot find them in Beirut, no matter how solid Lebanese banks are, they will go straight to other financial centres. Therefore, here again the contribution of the BL cannot be relied upon.

5. THE BL AND THE BANKING SECTOR

One last thing to consider is whether the BL will be able to control the volume of credit issued by banks in Beirut. This is interesting to consider, because, apart from the "national sovereignty" argument, it seems to have been the main impetus for the establishment of the BL:

> "At least to us economists, the Law of August 5 1963 has deprived us of one of our major topics of criticism; the non-existence of a Central Bank in Lebanon .... Is then Lebanon's banking sector - the altar of its economy - like any other banking sector in any other country, subject to control by a hideous, impressively domineering creation of modernistic trends - the Central Bank?"[1]

The BL received all the traditional tools of monetary control, as can easily be seen from Chapter I - discount rate changes, ceilings on rediscounting, open market operation, variable reserves requirements. These are the measures mentioned specifically, but it is noted - Article 76 - that the Bank has the right to take any measure felt necessary to regulate bank liquidity and the volume of credit. However, the emphasis is mainly on those traditional weapons of control, and in Chapter IV we tried to show why these measures will not work, and why other measures - such as limiting the percentage of advances and selective credit controls - were preferable. These could still be adopted under Article 76 but in the very short time the BL has been working it has already imposed a ceiling on rediscounting.

1. Saba, E. "Lebanon's New Banking Law", Middle East Forum, February March 1964, pp. 12-13.

This move quite apart from being ineffectual as far as the volume of credit is concerned, is going to make the banks more eager to be independent of the Central Bank for funds, and to rely still more heavily on the Marché Hors Banque. It will make the traditional weapons of control even less efficient.[1]

We conclude that even in the field of monetary control the BL is ill-adapted to the requirements of the country. As it is, it will be little more than an Issuing Bank, although the intention was to make it a Central Bank.[2]

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1. Article 76d stipulates that the reserve ratios to be imposed by the Central Bank will be calculated on deposits in Lebanese Pounds only. This may well encourage banks to prefer even more foreign currency deposits to Lebanese currency deposits, and might induce them to increase further the interest differential that exists at present between the two. On the one hand this might weaken the position of the Lebanese Pound in the foreign exchange market, as people buy foreign currencies and sell Lebanese Pounds. On the other hand it might well prove ineffective as banks do lend significantly foreign currencies which can be used for any ordinary transaction in Beirut.

2. In contrast with the BSL which was intended to be an Issuing Bank and came then to assume certain central banking activities.

CONCLUSION

We should now be able to reply to the questions posed in Chapter I. These were, whether or not the system with the BSL was adequate for the economic development of the country and if not, what sort of a change was required. It is clear that the BSL - although it fulfilled its role properly - was no longer adequate for the future. A Central Bank was required for the future development of the country and the role that such a Bank would play was described in Chapter IV. Lebanon was given a Central Bank, the Bank of Lebanon, but as we have tried to show there is little it can do to promote the exploitation of the financial potential of the country for its development.

It may be asked whether anything was achieved by the establishment of the BL. There are two answers to this question depending on how we interpret it. If it is taken to mean whether the BL by itself has made much difference, the answer is clearly 'no', for economic matters - as opposed to political matters, such as national sovereignty and prestige. Although on paper the BL has more powers than the BSL, it cannot in practice, do much more, as we have tried to show.

But, if we consider the question whether anything was achieved by the creation of the BL in a wider context, including the whole of the Code de la Monnaie et du Crédit which set up the Central Bank, the answer is different. In effect, what was achieved was the creation of a financial infrastructure with the BL at its head. As described in Chapter II banking in Lebanon was totally unregulated, and although its performance generally speaking was good, certain regulations and checks had to be imposed to stop abuse and the dishonesty of some bankers which could cause harm to the whole banking sector, as indeed happened in March, 1964. This was achieved to some extent in the Code and the new set of rules described in Chapter I govern the establishment of new banks, their structure and their investments, and balance sheets have now to be submitted monthly to the BL for inspection.

Finally, if all that was intended was the regulation of the banking profession in Beirut, without creating a Central Bank, a banking commission at the Ministry of Finance could have performed the job. However, the original intention was to create a Central Bank that would do more than the BSL, and that would take an active part in the economic development of the country. But the part it was to play was still visualised as the control by traditional means of commercial banks with the object of stabilizing the economy. In Chapter I we discussed the implications of such an approach. Now we see how it produced in Lebanon a classical model of a Central Bank that conforms to general descriptions of the Bank of England and other central banks of highly developed countries with different problems to deal with, but is ill-adapted to the needs of the country in which it is to operate.

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