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Foreign Aid and Economic Development in Postwar Lebanon

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Abstract

This paper shows that foreign aid in postwar Lebanon passed through two phases with distinct features that have had far reaching implications for postwar development. In the first phase lasting from 1992-97, foreign aid was mainly channelled towards providing resources for postwar reconstruction projects. The second phase from 1997 to the present witnessed a qualitative shift in foreign aid utilization from reconstruction needs towards financial stability and balance-of-payments equilibrium needs. This shift allowed the government to intervene in the foreign exchange market, maintained balance of payments surpluses during this period, reduced interest rates on public debt instruments and finally provided the necessary liquidity and 'confidence' for the government to continue borrowing funds from local commercial banks and foreign investors. More importantly this shift in foreign aid allowed the government to avoid financial and currency crises in 2002. However, the cost of such a qualitative shift was large in terms of fiscal management, diversion of funds from reconstruction, and the increased dependency of the Lebanese economy on foreign aid for stabilization purposes.

Keywords: foreign aid, postwar reconstruction, post-conflict, Lebanon

JEL classification: D74, E52, O23, H56

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Acronyms

BdL	Banque du Liban; Bank of Lebanon
CDR	Council of Development and Reconstruction, Lebanon
ERBS	exchange rate-based stabilization
MOF	Ministry of Finance, Lebanon
ODA	official development aid

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1 Introduction

Lebanon experienced a civil war that lasted for more than 15 years from 1975 to 1990. The duration and severity of the war led to a huge devastation of the physical, human and social capitals. A review of the physical and human losses—such as lost output estimated at US$24 billion in 1986; reduction in GDP per capita by around 67 per cent; 131,000 war deaths, and the emigration of 500,000 inhabitants, mainly high-skilled workers—points to the huge challenges that were confronted in the immediate postwar period of economic reconstruction (Dibeh 2005). In this respect, foreign aid was considered an important element of the postwar reconstruction process. The national reconstruction programmes implemented in the post-1992 period included substantial foreign aid and loans component that were deemed necessary for resource provision for the ambitious programmes. However, Lebanon's reconstruction challenges proved to be daunting and these spanned the often conflicting needs of reconstruction, fiscal management and financial stability. The early promises of vast amounts of foreign aid, mainly from Arab sources after the signing of the Taif Peace Accords in Saudi Arabia in 1989, did not materialize as the early postwar governments had hoped. The Syrian hegemony over Lebanese political affairs in the post-Taif period led the United States, France and Arab countries to refrain from the provision of funds for reconstruction as promised. Hence, the Lebanese government decided in 1992 to follow a two-pronged approach to reconstruction: utilization of foreign funds for immediate reconstruction projects and reliance on internal funding for deficit-financing and exchange rate stabilization. Lebanon's main source of internal funding was the well-developed commercial banking system.[1] Traditionally the commercial banking sector has been the strongest sector in the economy before the war when Lebanon was considered a major regional financial centre. The banking system in the immediate postwar period was able to attract capital inflows from foreign sources and from the large pool of Lebanese immigrants whose remittances have traditionally supplied the country with a large share of its foreign currency needs. This postwar open economy approach helped Lebanon revolve its financing difficulties stemming from the lack of national savings and adequate foreign aid (Gressani and Page 1999).

The complexity of the Lebanese experience in relying on foreign aid both for reconstruction and development and for fiscal balance and financial stability—coupled with internal funding mechanisms—makes Lebanon an important case study of the relationship between foreign aid and postwar development priorities. In addition, the study of the effect of foreign aid on the postwar Lebanese economy takes on a new urgency as Lebanon prepares to receive a new wave of foreign aid estimated at around US$7.6 billion pledged by international donors during the Paris III Conference in January 2007. This conference came at the heels of the most radical political developments in Lebanon in the past two decades. The assassination in February 2005 of the late prime minister, Rafic Hariri, the symbol of postwar reconstruction, led to massive protests, resulting in the withdrawal of Syrian troops in April 2005 that had been present in the country since 1976 and had been the main enforcer of the Taif Accords that ended the civil war in 1990. New elections were held in May and June 2005, bringing an anti-Syrian majority into parliament and government. The new reform programme prepared for the Paris III Conference, promised significant economic and

1 The importance of the role of the banking system in providing funds for reconstruction and the private sector in postconflict societies is discussed in Addison et al. (2001).

structural reforms including privatization, tax increases, labour law reform and reforms to the social security system.

The paper is divided as follows. Section 2 delineates the different types and phases of foreign aid in Lebanon. Section 3 concentrates on the study of the early sources of funding that were geared specifically for the reconstruction phase 1992-97. Section 4 briefly discusses macroeconomic developments during the postwar era up to the period preceding the international donors conference held in November 2002, known as Paris II. Section 5 discusses the Paris II meeting and its fiscal and economic effects, while section 6 concludes.

2 Forms of foreign aid in the postwar period

It is rather paradoxical that Lebanon, currently in its 16th year after the official end of hostilities, is still in need of foreign assistance on a massive scale (even more so than before). This is a long time, given that the lifecycle of foreign aid in postwar reconstruction programmes is in the order of few years (Kang and Meernik 2004). Although Lebanon is beyond the reconstruction phase, this chronic need for continuous foreign aid was the result of the failures of the economic policies conducted in the immediate era of the postwar reconstruction phase (for details see Dibeh 2005). These developments attest to the fact that Lebanon failed in its postwar reconstruction effort to develop a ‘self-sustaining order’, a prerequisite for the success of postwar reconstruction (Coyne 2005). In this respect, foreign aid in postwar Lebanon passed through two phases with distinct features. The first phase, lasting from 1992 to 1997, can be dubbed as a ‘classical phase’ when funds were channelled towards providing resources for the reconstruction projects envisioned in the various postwar reconstruction programmes (Helbling 1999). Foreign aid was aimed at financing the massive infrastructure rebuilding in the areas of electricity, water, and telephone and road networks. Most of this foreign aid was channelled through the Council of Development and Reconstruction (CDR), the government agency established in 1981 amidst the civil war. However, a small share of the reconstruction needs were financed through foreign grants compared to foreign loans, even though official development aid per capita (ODA) in postwar Lebanon was high in comparison to ODA in the post-conflict low-income states in Sub-Saharan Africa.

The second phase, which spans the period from 1997 to the present, witnessed a qualitative shift in foreign aid utilization from the demands of reconstruction towards needs for financial stability and balance-of-payments equilibrium. Foreign aid geared towards reconstruction dwindled from the 1997 budget onwards while foreign aid in the form of foreign exchange reserve deposits with the central bank and foreign currency grants and soft loans increased tremendously. One type of foreign aid was aimed at propping up the Lebanese balance of payments and the central bank foreign exchange reserves through direct deposits with the central bank. This type of aid was intermittent and sparse, but came at crucial times when the Lebanese currency, stabilized in the postwar period, was under severe pressure resulting from economic and political developments. The foreign aid came mainly from countries within the region, such as Saudi Arabia. This shift in the purpose of foreign aid was codified with the Friends of Lebanon Conference held in Washington in 1997 and continued with the Paris II meetings held in late 2002. The new phase of foreign aid enabled the government to achieve several objectives. First, the central bank was able to intervene in the foreign exchange market to defend the currency given the inflow of foreign capital. Second, Lebanon was able to maintain balance-of-payments surpluses during this period. Third, capital inflows led to a reduction in interest rates on public debt instruments and finally provided the necessary liquidity and 'confidence' for the government to continue borrowing funds from local commercial banks and foreign sources. Overall, this shift in foreign aid allowed the government to sidestep financial and currency crises, particularly as a result of the Paris II meetings when approximately US$2.4 billion was received in the form of soft loans for debt restructuring. In the post-Paris II meetings period, interest rates on the both dollar and Lebanese pound denominated debt instruments plummeted, commercial bank liquidity soared and balance of payments went into surplus.

3 Foreign aid for reconstruction

Foreign aid and postwar reconstruction have been closely linked since the implementation of the Marshall plan for the reconstruction of Europe in the post-Second World War period. In more recent times, foreign assistance has been instrumental in providing the necessary resources for postwar reconstruction in many war-torn countries, including Iraq, Afghanistan, Bosnia, Kosovo and west African states. In many instances, foreign aid was the only source of funds for reconstruction; in Sierra Leone, for example, post-conflict reconstruction was funded by foreign sources such as the UN, UK and foreign NGOs. The scale of foreign aid to GDP and to reconstruction needs has been staggering (Grant 2005). Kosovo is totally dependent on foreign aid for reconstruction and for current expenditures on the day-to-day running of the affairs of the province in many areas such as education, energy and security.

The Lebanese government, through the Council for Development and Reconstruction (CDR), its principal reconstruction arm, vigorously implemented an infrastructure reconstruction programme in the post-1992 period. The emphasis on infrastructure development was a reflection of the severe damage and destruction that the infrastructure in all its variations—physical, basic services and otherwise—had suffered during the long civil war as a result of direct destruction or years of neglect and lack of maintenance. In these situations, such an emphasis on infrastructure is highly justified (Anand 2005). The main reconstruction projects were envisioned in the Horizon 2000 Plan that went through different forms during 1992-95. Public investments, totalling US$17.7 billion, were to be allocated to physical infrastructure, social infrastructure and public services. As of December 1997, foreign financing of the 1992 reconstruction programme totalled US$4.0 billion, with US$3.5 billion in loans and US$0.5 billion in grants with the loans component consisting of soft loans and commercial loans with export guarantees (Wetter 1999). Table 1 shows that during this period foreign aid in the form of soft and concessionary loans and grants awarded to the government formed a significant share of total public capital expenditures. Table 2 shows the extent of foreign financing of reconstruction needs during the periods 1992-97 and 1998-2004.

After this period, foreign loans and grants for reconstruction were greatly reduced. The reconstruction phase of postwar development was nearing its end. By the end of 2004, the total amount of foreign financing, including all types of loans and grants, was around US$5.8 billion. The temporal allocation shows that around 70 per cent of foreign financing was allocated during the 1992-97 period compared to only 30 per cent during 1998-2004 (see Table 2).

The source of funding for reconstruction was overwhelmingly from international institutions, Arab Gulf countries and institutions, France and Italy. Table 3 shows the distribution of source of funding from major donors.

Table 1
Foreign loan, grants and public investments as shares of GDP, 1992-97

	1992	1993	1994	1995	1996	1997
Grants/GDP, %	0.0	1.5	3.3	0.4	0.3	0.3
Foreign loans/GDP, %	-1.1	2.6	7.8	4.9	4.2	3.5
Public capital expenditure/GDP, %	1.5	3.4	9.3	9.4	8.5	8.6

Source: Helbling (1999).

Table 2
Foreign aid and reconstruction expenditures, 1992-2004

	1992-97	1998-2004
Reconstruction expenditures (US$ billion)	4.2	7.4
Foreign aid (US$ billion)	4.0	5.85
Ratio, %	95.0	79.0

Source: Wetter (1999) for the period 1992-97; CDR (2005) for the period 1992-2004.

Table 3
Main sources of funding for Lebanon's reconstruction, 1992-97 and 1992-2004

Source	1992-97 (%)	1992-2004 (%)
World Bank	15.0	14.0
Arab Fund	12.6	13.0
European Investment Bank	12.5	14.0
Saudi Arabia + Saudi Fund	9.7	7.0
Italy	8.5	6.0
Kuwait + Kuwaiti Fund	6.8	10.0
France	6.8	6.0

Source: Wetter (1999) for the period 1992-97; CDR (2005) for the period 1992-2004.

Table 4
Planned and realized public investments in various sectors, 1992-2004

Type of investment	Horizon 2000 1993-97	Achieved 1992-97	%	Achieved 1992-2004	% of Horizon 2000
Physical (US$ million)	3,200	2,206	69	3,431	107
Social	1,930	553	29	970	50
Public services	980	615	63	1,856	190
Productive and others	1,236	778	63	1,145	93

Source: Calculations by author from Wetter (1999) and CDR (2005).

The originally planned public expenditures targets were not met although the reconstruction programme itself was successful in restoring the main physical infrastructure such as electricity, roads and telecommunication networks and basic services. The failure was partly due to the shortfall in adequate foreign funding that had been hoped for at the end of hostilities and in drafting the various reconstruction plans, particularly Horizon 2000.

Postwar reconstruction plans were delayed, and during 1992-97, only around 60 per cent of the planned projects were realized or were in the process of being completed. It was not until the end of 2004 that the 1992-97 plans for the physical and productive sectors (including airport and ports) were fulfilled. But the social sectors were most severely affected by the unrealized plans; only 50 per cent of the original expenditures in this sector for the period 1992-97 were achieved by the end of 2004 (Table 4).

Moreover, allocation of funds between the different sectors for the reconstruction programme was, in many respects, far from what was envisaged in the Horizon 2000, which had proposed a balanced disbursement of resources among the different sectors damaged by the prolonged war. As Table 5 shows, actual allocation during the period 1992-2004 did not favour the social infrastructure sector.

Table 5
Planned versus realized sectoral allocation of reconstruction plans

Type	1992-97	1992-2004	Horizon 2000
Physical infrastructure, %	52.0	46.3	37
Social infrastructure,%	13.0	13.1	25
Public services, %	14.6	25.1	22
Productive and other (incl. government buildings and ports),%)	20.4	15.5	16

Source: Calculations by author from Wetter (1999) and CDR (2005).

4 Macroeconomic policy and developments, 1992-2002

Postwar reconstruction in Lebanon was carried out with simultaneous fiscal and monetary stabilization efforts that were deemed necessary after the long inflationary period from 1984 to 1992. In 1992, government budget deficit was 15 per cent of GDP while the inflation rate was 120 per cent. Lebanon was also facing an impending balance-of-payments crisis, with a surplus of only US$54 million compared to US$1,074 million in 1991 (BdL 1993). To fight inflation and achieve external balance, in 1992 the first Hariri government and the central bank used the nominal exchange rate as an anchor in the post-1992 stabilization programme in a typical exchange rate-based stabilization (ERBS). The ERBS policy was based on a requirement of high foreign exchange reserves and discontinuation of the inflationary finance policy that characterized government spending in the 1980s. This policy was successful in bringing down the inflation that had averaged 110 per cent annually during 1986-92 (BdL 1993) to an acceptable 10-12 per cent level by 1995. In contrast, fiscal policy was expansionary, because of the demands of reconstruction, the needs of state-building, especially the army and security apparata, and social expenditures. The deficit to GDP ratio, after an initial drop in 1993, reverted back to its pre-1992 levels.

Table 6
Public debt and deficits of postwar Lebanon, 1993-2002

Year	Deficit/GDP, %	Debt/GDP, %
1993	9.01	34.4
1994	19.3	43.5
1995	15.6	51.3
1996	18.2	79.9
1997	23.6	96.6
1998	14.1	105.4
1999	14.4	120.0
2000	23.6	141.0
2001	16.9	170.0
2002	16.5	181.0

Source: Dibeh (2005) for the years 1992-2000; calculations by author from Audi Bank (2005) for 2001-02.

Table 7
GDP, inflation rates and real interest rates in postwar Lebanon

Year	Real GDP growth, %	Inflation rate, %	Real interest rates, %
1992	4.5	131.0	-105.4
1993	7.0	24.7	13.3
1994	8.0	8.0	1.9
1995	6.5	10.6	4.1
1996	4.0	8.9	7.6
1997	3.5	7.7	6.4
1998	3.0	1.6	9.83
1999	4.0	1.5	9.38
2000	2.0	-0.9	11.78
2001	1.4	2.9	8.0
2002	1.0	4.2	6.6

Source: UNCDB (nd) for GDP growth; Eken and Helbling (1999) for inflation rates, 1992-97; Audi Bank (2005) for inflation rates, 1998-2002; author calculations for real interest rates (real interest rate = 3 months T-bill rate minus inflation).

Table 8
Foreign direct deposits with the Central Bank of Lebanon

Year	Type
2001	- Deposits solicited by Hariri from Arab governments totalling ~ US$1 billion
	- Loan of US$1 billion, of which US$500 million went to boost CB reserves
1997	- Saudi deposit of US$600 million at the CB
1997	- Kuwaiti deposit of US$100 million at the CB

Source: Various sources.

The expansionary fiscal policy, coupled with the 1993 supply-side tax reforms that reduced taxes on profits, salaries, capital incomes among others, led to a growth of the country's public debt to unprecedented levels. The combination of large expenditures and low taxes caused a continuous widening of the budget deficit and hence the accumulation of further public debt. Given the state's decision to renounce inflationary finance, deficits were financed with the issuance of T-bills denominated in Lebanese pounds. Starting in 1998, as the fiscal deficit increased, the government started looking for external finance markets through the issuance of what came to be known as Eurobonds. This was reflected in a discrete jump in external debt as of 1998. Table 6 summarizes budget deficits and how public debt has evolved in the postwar period.

The postwar macroeconomic policy mix led to a sharp increase in nominal and real interest rates, having positive effects on the external balance and on the subscription rates in T-bills and bonds issued by the Lebanese government. Urnéchlian, Eken and Helbling (1999) show that in the context of the ERBS policy, the average annualized excess returns on short-term T-bills in the mid 1990s were around 16 per cent. Such development, however, had a negative consequence for the real economy. The ERBS policy, in conjunction with persistent deficits and growing public debt, led to sluggish economic growth and triggered a boom-bust cycle that put an end to the short-lived postwar reconstruction boom (Dibeh 2003, 2007). After an initial short-lived postwar reconstruction boom, Lebanon faced a period with real GDP growth in 1998-2002 developing at rates well below the early postwar era. It is noteworthy that the recession was accompanied by disinflation and even deflation. Moreover, the recession coincided with diminishing credit to the private sector and accelerating credit by the banking sector to the public sector. The growth cycle was accompanied by investment and consumption cycles that reflected the diffusion and depth of the business cycle experienced in this period.

Starting in 1997, the Lebanese government led by Rafic Hariri sensed the unsustainability of the postwar macroeconomic policy. The fiscal crisis, coupled with the ERBS policy, was causing high real interest rates, unsustainable deficit and public debt growth and economic recession. The growing public debt and economic slowdown were tackled with the convening of the donors conference, Friends of Lebanon, in Washington in December 1997 when the government proposal included projects valued at US$5 billion to be financed over five years through grants and soft loans. Pledges of around US$1 billion were made for 1998. But the United States promised to increase its funding for Lebanon to merely 'more than US$20 million'. This 'foreign leap' by the country in 1997 was to become the main policy-response of successive Hariri governments in the face of successive economic challenges and crises.[2] Foreign aid via donor conferences and direct deposits with the central bank were to become the government procedure for resolving the macroeconomic imbalances during this period. The direct deposits with the Central Bank of Lebanon occurred at two crucial junctures: in 1997 and 2001 (Table 8). During both periods, the central bank was losing reserves and the currency came under severe market pressure. The deposits acted to prop up the reserves and calm the currency markets and restore confidence in the Lebanese currency

2 Except in the 1998-2000 period when an anti-Hariri government was in power. The government devised a reform plan that articulated necessary reform measures, but the programme was never implemented.

but more importantly also in the ability of the government to mobilize foreign funds at times of crises.

After the Israeli withdrawal from south Lebanon in May 2000, the government with the assistance of the UNDP prepared another US$5 billion plan. Hoping for foreign aid to finance the plan, the government appealed to the international community for help in the reconstruction of the southern regions. But due to mounting political pressure on the Lebanese government from the US and the west to send the army to the south, foreign aid was not forthcoming even from seemingly sympathetic Arab countries. As a result of the mounting pressure, the US Congress blocked a US$35 million aid package to Lebanon in 2001 and Arab Gulf countries allocated only around US$100 million in loans and grants. By 2001, the economy was showing signs of a severe strain and a possible financial crisis was widely forecasted by many. The internal financing schemes for postwar reconstruction as well as the fiscal and monetary policies of the successive postwar governments were taking their toll on the economy. Up to this point, the political economy in Lebanon with regard to debt financing had been able to prevent currency and financial crises. The state/commercial banks nexus provided political-economic support for stable currency and financial markets. The IMF recognized that Lebanon, through balance sheet interconnections between commercial banks and government, was able to sustain the high levels of government deficits and the spiralling public debt without the collapse of the currency, as had been predicted by many observers, including the IMF itself (IMF 2004). However, this state of affairs could not be sustained beyond 2002. Continuing pressure on the Lebanese government by both the local commercial banks that would bear the brunt of any government default or currency collapse and by the IMF was becoming too great. The consultation team at IMF for Lebanon called on the country in December 2001 to devalue its currency, which was met by widespread objections within both the government circles and the commercial banking sector. As a consequence of such adverse economic and political developments, the newly formed Hariri government embarked on preparations for holding the Paris I meeting in February 2001 which was a preliminary meeting of potential international donors. This preparatory meeting led one year later to the convening of the Paris II Conference held in November 2002.

The macroeconomic and stabilization policies, coupled with the foreign aid in its post-1997 form, also played a role in the deindustrialization process that occurred during the postwar period. The ERBS policy and the insatiable need for foreign inflows to finance the chronic budget deficits through the banking system have maintained real interest rates at high levels throughout the postwar period. Furthermore, commercial credit to the private sector stagnated and was crowded-out by the commercial banks supply of credit to the public sector. This worked to skew the Lebanese development towards a rentier-based economy with Dutch disease effects.[3] In Lebanon, the process of deindustrialization in the postwar period was significant and unparalleled in an economy undergoing postwar reconstruction, when its average annual growth rate for industry from 1993 to 2003 was -0.4 per cent and for manufacturing -1.8 per cent per annum (World Bank database).

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3 The role of foreign aid in engendering Dutch disease effects have been documented in many studies (Bulir and Timothy 2002; Vos 1998)

5 The economic effects of the Paris II meetings

The Paris II meetings held in November 2002 were a landmark event in the postwar period. The donors conference was attended by many countries and multilateral institutions such as the World Bank and the IMF. The official goal for convening the Paris II Conference was to seek international support for the Lebanese reform programme that included a reduction in debt to GDP ratios, budgetary restraint and better growth prospects in the medium run (MOF 2003). Even though the government paper presented at the Paris II meeting was titled 'Beyond Reconstruction and Recovery Towards Sustainable Growth: A Request for International Support', the government's immediate aim was to prevent an imminent fiscal and financial crisis. Lebanon asked for concessionary loans and grants that would help to pay off a part of its debt, to extend debt maturities and to reduce the interest rate on public debt in addition to favourably changing the structure of interest rates in the economy as a whole. International lenders were forthcoming with concessionary loans, as can be seen in Table 9 with regard to the amounts of foreign funds disbursed by the various countries and institutions.

One of the main interesting features of Paris II was the engagement of the powerful internal financial players in Lebanon in the rescue package. The central bank pledged US$4.2 billion, and the commercial banks, whose role in the financing of public debt up to that point has provided them with windfall profits, also pledged to subscribe to US$3.6 billion worth of 2-year T-bills at zero per cent interest. The package received by the Lebanese government totalled in all US$10.1 billion. Such an inflow of funds into Lebanon and into the state treasury provided the country with opportunities for economic growth and macroeconomic adjustment unprecedented in its postwar economic history. There were many positive effects of the foreign concessionary loans and the matching subscription by the central and commercial banks of Lebanon (Table 10 and Figure 1): (i) public debt growth decelerated; (ii) the cost of government borrowing both in LP and dollar-denominated debts was significantly reduced; (iii), and more importantly from a macroeconomic perspective, market interest rates on both LP and dollar-denominated commercial loans went down; (iv) the foreign exchange revenues of the Bank of Lebanon increased; and (v) the balance of payments improved significantly. As a result, it can be said that the Paris II meetings helped Lebanon avert a financial crisis and laid the foundations for economic recovery.

Table 9
Foreign loans secured in Paris II meetings

Country/agency	Amount (million)	Conditions
Saudi Arabia	$700	15 years, 5-year grace period, 5 % interest
Kuwait	$300	same
UAE	$300	same
Qatar	$200	same
Malaysia	$300	same
Oman	$52	same
France	€500	15 years, 3-year grace period, 5% interest
EU	€12.25	grant
Arab Monetary Fund	$15	Medium-term loan

Source: MOF (2003).

Table 10
Interest rates, reserves and balance of payments: before and after Paris II

	Cost of borrowing	Debt: LP-denominated	Debt: $-denominated	Market interest rate: LP	Market interest rate: US$	BdL reserves	Balance of payments
	%	%	%	%	%	US$ bn	US$ bn
Before Paris II	11.97	13.82	9.21	16.10	9.62	3.5	0.3
After Paris II	8.36	9.23	7.39	10.48	7.89	10.4	3.3

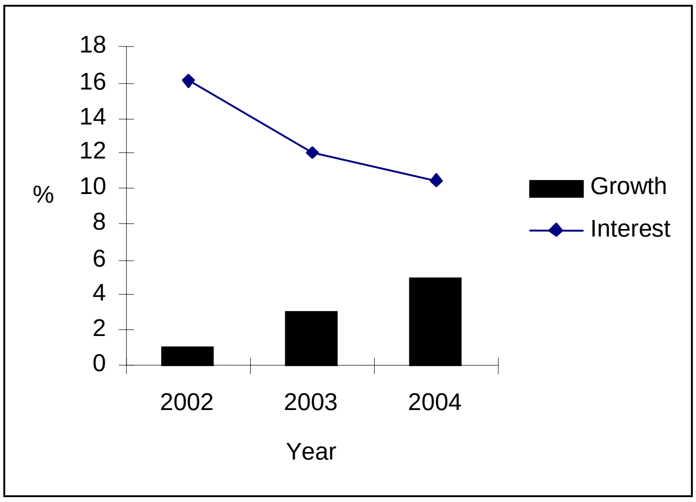
Source: MOF (2003) and BdL database.

Table 11
Projected and actual debt-to-GDP ratios (per cent)

	2003	2004	2005
Projected	136	126	114
Actual	174	164	160

Source: MOF (2003) and Audi (2005).

Figure 1
Economic growth and interest rates in post-Paris II period



Source: MOF (2003).

Despite these positive effects of the Paris II meetings on the state of government finances and on money markets, they failed to make a lasting impact on one of the most worrying trends in the Lebanese postwar economy: the growing debt to GDP ratio. Table 11 shows the difference between the projected (according to the government Paris II paper) and actual debt-to-GDP ratios in the post-Paris II period.

Moreover, in the post-Paris II meetings, the Lebanese government failed to implement the promised structural reforms such as administrative reform, fiscal restraint and privatization that had been put forth in its paper to the conference. This failure can be attributed to the negative impact on the fiscal and reform response of successive Lebanese governments as a result of foreign aid aimed at short-run stabilization needs. In general, starting in 1997, the shift in the purpose of foreign aid was a disincentive for fiscal and economic reforms by successive postwar governments.[4]

6 Conclusion

This paper has shown that foreign aid in postwar Lebanon passed through two phases with distinct features that have had far-reaching implications for postwar development. In the first phase, lasting from 1992 to 1997, foreign aid was mainly channelled towards providing resources for postwar reconstruction projects. The second phase from 1997 to the present witnessed a qualitative shift in foreign aid utilization from the needs of reconstruction towards financial the needs of stability and balance-of-payments equilibrium. This shift allowed the government to intervene in the foreign exchange market, maintained balance-of-payments surpluses during this period, reduced interest rates on public debt instruments and finally provided the liquidity and 'confidence' necessary for the government to continue borrowing funds from local commercial banks and foreign investors. More importantly, this shift in foreign aid allowed the government to avoid financial and currency crises in 2002.

The experience of postwar Lebanon has shown that the macroeconomic policy mix is a crucial element in postwar reconstruction and economic development. Macroeconomic imbalances can push governments to sideline reconstruction programmes. Such needs and programmes in Lebanon were all but forgotten by 1997 with the mounting macroeconomic pressures. The government shifted its priorities from reconstruction despite the country's lagging economy in terms of reconstruction success indicators such as economic growth, GDP per capita and capital accumulation in comparison to other postwar economies. For example, in the Paris II meetings, the US$1.3 billion pledged for 'socioeconomic development' never materialized nor did the Lebanese government make an attempt to secure the funds by providing a list of potential projects. During and after the meetings the government effort was put overwhelmingly towards securing loans for public debt restructuring.

The current state of economic crisis in Lebanon that intensified in the aftermath of the July 2006 Israel-Lebanon war pushed the government to call for the holding of the international donors conference that had initially been planned to be held in Beirut. The conference (Paris III) was finally held in Paris in January 2007, and raised around US$7.6 billion of pledges in soft loans and grants in support of the Lebanese government economic and fiscal reform programmes. The conference was seen as a sequel for the Paris II meetings. The political blame on the failure of the Paris II meetings was put on the president of the republic and on the pro-Syrian political parties. However, the international community, including the IMF and the United States, has implicitly blamed the whole political system in Lebanon for the non-implementation of the reforms promised at the Paris II meetings. In early 2006, the United Sates, through its ambassador in Lebanon, called for the country to undergo supervision by the IMF for

4 Such behavioural effect of donor aid on the fiscal stance of governments in the developing world and in post-conflict societies has been studied by McGillivray and Morrissey (2004).

any funds to be disbursed at future donors meetings. In April 2007, the IMF and Lebanon signed a US$76.8 million loan agreement under the Emergency Post-Conflict Assistance Programme. The IMF will monitor developments in 2007 regarding the implementation of the reform plan, and the donor countries will take into consideration these reports in their final decision to disperse funds pledged at Paris III. Moreover, the IMF and Lebanon are expected to sign a larger loan agreement next year under an IMF stand-by arrangement. Such agreement would impose some form of IMF conditionality on Lebanon. The dependency on foreign aid for stabilization purposes has led Lebanon to become a candidate for IMF conditionality which, if realized, will have negative effects on income distribution and poverty.

Apart from the specific conditionality enforcement and accountability mechanisms that will be developed, Paris III meeting should be seen as an opportunity for Lebanon to embark on the path of sustainable development. This sustainable development must be a new phase in the postwar economy of Lebanon that makes a break with the past with regard to the country's dependence on foreign loans and aid for reconstruction and macroeconomic stability.

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