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Syria's War Threatens Lebanon's Fragile Economy

The Syrian civil war is accelerating Lebanon's political and institutional decline and poses a serious long-term threat to its economy. Lebanon has largely been spared the political upheavals of the Arab Spring, its fractious political system is intact, and the weakness of its central government means there is no authoritarian order to revolt against. However, Lebanon's own political dysfunction, the regional powers' stakes in Lebanese politics, and their anxieties over the geopolitical challenges that the Arab uprisings pose magnify the economic dangers of Syria's disintegration.

With no end to the Syrian conflict in sight, Lebanon faces the prospect of a protracted economic crisis that poses a threat to political stability, domestic and regional security, and citizens' quality of life. Lebanon is a small country with insignificant military capability, and the political order in Syria profoundly shapes its security and economy. A serious deterioration in the Lebanese economy would accelerate the state's weakening control over its territory, and further destabilize Syria as well. Lebanon has endured years of frequently violent political conflict, in addition to intermittent, economically disastrous wars between Hezbollah and Israel. It is unclear how much more pressure the Lebanese economy can withstand.

Lebanon already faced serious economic challenges including high unemployment, a high debt-to-GDP ratio, and weak public finances before civil strife started in Syria. The regional and domestic political environments make it unlikely that the state will be able to meaningfully address these issues in the short term. Barring a total collapse of security in Lebanon however—which is admittedly a growing possibility given the war in Syria—the state can concentrate on forming a government, managing the Syrian refugee issue, and pursuing relatively uncontroversial reforms aimed at keeping the economy afloat. This requires that the political elite resist prioritizing their parochial interests and holding economic policymaking hostage to the course of fighting in Syria.

Rafik Hariri Center for the Middle East

The Rafik Hariri Center for the Middle East at the Atlantic Council studies political transitions and economic conditions in Arab countries and recommends US and European policies to encourage constructive change.

Snapshot of the Lebanese Economy

Lebanon has many features of a dynamic economy, but prosperity has eluded it. After its fifteen-year civil war ended in 1990, it re-emerged as a highly open economy, with free movement of goods and capital and an educated workforce. The war and ensuing peace accord, however, failed to resolve Lebanon's political contradictions, or to lay the groundwork for a lasting peace that could protect Lebanese politics and the economy from regional crises. In addition, the economic model that Lebanon adopted after the war was flawed in its conception and implementation, and impeded the achievement of sustainable and inclusive growth.

Lebanon's gross domestic product (GDP) is $40 billion and its economy is dependent on its financial sector and relies heavily on tourism, real estate, and diaspora spending and remittances. The country saw a major reconstruction effort following its civil war, experiencing strong growth in most years. However, its inability to attract substantial foreign investment and limited ability to raise revenues forced the government to borrow heavily in international and domestic markets to fund reconstruction. Public debt reached some $55 billion, raising Lebanon's debt-to-GDP ratios to more than 135 percent—one of the highest in the world.

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The state's heavy dependence on borrowing from domestic banks highlights the banking sector's central role in the economy. Lebanese bank deposits measured some $128 billion in March 2013—more than three times the nation's GDP. Banque du Liban (BDL), the central bank, has emphasized currency stability and amassed large foreign currency and gold reserves to defend against any pressure on the Lebanese pound, which has remained stable. By requiring banks to hold high reserves against customer deposits, and restricting investments in derivatives and other relatively risky financial instruments, BDL helped protect the banking system from external economic and political shocks.

An estimated 15 million Lebanese live abroad compared to only 4 million at home, giving the diaspora a critical role in the economy. Many Lebanese have maintained strong social and economic ties to their country, visiting frequently, investing in property, and otherwise contributing through remittances. On the other hand, the diaspora's growth reflects the high emigration rates among skilled workers. Lebanon loses some 45 percent of its university graduates through emigration every year.[1]

Lebanon is also highly dependent on tourism, which in 2012 accounted for nearly 10 percent of GDP and 9 percent of total employment.[2] This highlights another critical aspect of the economy: the diaspora and Gulf Arabs together constitute the bulk of tourists and a vital source of investment, including in the banking sector. In addition to Syria, the United Arab Emirates, Saudi Arabia, and Iraq are Lebanon's main trading partners and receive nearly half of its exports.

Historically, the economies of Syria and Lebanon are deeply intertwined through trade (including substantial black market activity), migrant labor, and tourism. Lebanon has long been the main recipient of Syrian exports, capital, and workers. Since the Syrian war began, Lebanon has experienced a slowdown of 0.2 percent in its economy for every 1 percent slowdown in Syria's.[3] It is through this dependence on the Syrian economy, as well as Gulf investment and tourism, that war in Syria has had the most serious direct impact on Lebanon's economy.

Impact of the Syrian Crisis

It was inevitable that Lebanon's economy, with its main sectors vulnerable to external political shocks, its geographic proximity to Syria, and the complex interplay between Lebanese and Syrian politics, would feel the effects of the civil war devastating Syria. Although Lebanon has thus far avoided recession, the crisis has highlighted vulnerabilities in the Lebanese economy that will probably worsen as fighting in Syria persists, including the heavy dependence on tourism, remittances and real estate, and weak public finances. Lebanon's domestic political divisions over the Syrian civil war are also undermining both the economy and the state's ability to cope with and respond effectively to economic shocks.

In the year after the Syrian crisis started, in March 2011, Lebanon's real GDP growth fell by 5 to 6 percent. This was a consequence of falling foreign direct investment (FDI), a slowdown in the real estate sector, and a substantial drop in tourism. Unemployment registered around 10 percent, and youth unemployment was 25 percent.[4] The Lebanese economy fails to create enough skilled jobs to stem the 'brain drain' as some of the most talented and motivated Lebanese leave the country, and there is anecdotal evidence suggesting that this has accelerated over the last two years. The proximity and increasing involvement of the Bekaa Valley and northern Lebanon in the fighting in Syria is likely to deepen their populations' poverty and economic marginalization.

As foreign confidence in Lebanon's deteriorating security outlook plummeted, FDI fell 68 percent from $3.5 billion in 2011 to $1.1 billion in 2012.[5] Investor concerns are arguably well-placed: rival Lebanese factions have taken opposing

1 *Labor Migration from North Africa: Development Impact, Challenges and Policy Options*, Volume 1 – Main Report, World Bank (2010), **http://siteresources.worldbank.org/INTMENA/Resources/MIGRATIONREPORT.pdf**.

2 "Overview of the Recent Monetary, Banking and Financial Developments in Lebanon," *Banque du Liban*, **http://www.bdl.gov.lb/bdl/policy.htm**.

3 Dominic Evans, "Syria War Could Push Lebanon, Jordan into Slump," *Syrian Economic Forum*, May 9, 2013, **http://www.syrianef.org/En/?p=1617**.

4 Zafiris Tzannatos, "Unemployment in Lebanon," *Executive Magazine*, October 2, 2012, **http://www.executive-magazine.com/banking-and-finance/Unemployment-in-Lebanon/5237**.

5 "FDI Declines by 68 Pct in 2012 to $1.1 billion," *The Daily Star*, March 19, 2013, **http://www.dailystar.com.lb/Business/Lebanon/2013/Mar-19/210643-fdi-declines-by-68-pct-in-2012-to-11-billion.ashx**.

sides in the Syrian conflict—providing funding, refuge, and military support to the belligerents—and increasingly fighting one another in Lebanon itself. With the country's politicians, institutions, and population split along pro- and anti-Syrian lines, investors have little reason to expect improvements in Lebanon's deepening political dysfunction and security problems.

There may well be a political motive behind some countries' withholding of foreign investment as well. Gulf Arab countries are an important source of FDI in Lebanon, and their governments, particularly those of Qatar, Saudi Arabia, and the United Arab Emirates, are strongly opposed to the Syrian regime and its allies in the Lebanese government. The Gulf Cooperation Council (GCC) has accused Lebanon of failing to honor its pledge of neutrality in the Syrian conflict, due to the participation of Hezbollah—which dominates the cabinet—in fighting the Syrian rebels, and the Lebanese Army's targeting of Syrian rebels and their Lebanese supporters. While Saudi Arabia has denied any intention of drawing down its investments in Lebanon, there is speculation that this process is already underway.

The GCC's displeasure with government policies may also have contributed to the decline in Gulf Arab tourists in Lebanon, although the security situation was likely a more important factor, since many visitors from the GCC enter Lebanon by land from Syria. Since fighting began in Syria, Kuwait, Saudi Arabia, Qatar, Bahrain, and the UAE have all warned their nationals not to travel to Lebanon. Attempts to lure them with steep discounts have failed, which is understandable given that Gulf Arab tourists are generally wealthy and more likely to be concerned about security than hotel and airline prices. The number of foreign visitors fell from some 2.2 million in 2010 to less than 1.4 million in 2012, and specifically the number of Arab tourists fell by some 42 percent in the latter half of 2012 as security worsened.

Tens of thousands of Lebanese work in GCC countries and generate an important source of remittances that bolster the economy. Although remittances from expatriates held strong at some $7.5 billion in 2012, there are rumors that GCC countries are withholding or cancelling work permits for Lebanese, although their governments have denied this.[6] It is quite likely however that Gulf states have denied some residency permits due to suspicion toward Lebanese nationals suspected of having pro-Hezbollah sentiments. These suspicions have deepened in the context of Lebanese Shia support for the Syrian regime, against which Gulf states are effectively fighting a proxy war.

The real estate and construction sectors have also been adversely affected since fighting broke out in Syria, reflecting reduced domestic and foreign confidence. The property market, where GCC nationals' and government spending helped fuel a boom from 2007 to 2010, saw a decline in the number of transactions, and property prices have begun to stagnate. A decrease in new construction permits also indicated a reluctance to start new projects in the face of a worsening security and economic outlook.

The Syrian crisis' impact on Lebanon's foreign trade has been more complex. Agricultural exports to Syria actually increased in 2012, despite disruptions to overland trade due to border and road closures in Syria, and rebel attacks on trucks bound for Syria. Industrial exports to Syria, including cement, clothing, and woodcraft, also increased. However, in Lebanon loans to the agriculture sector and imports of industrial machinery both fell significantly, indicating a slowdown in the expansion of production in these sectors. Rising demand for Lebanese products in Syria, due to falling Syrian production resulting from fighting, fueled the increase in exports. In Lebanon itself, consumption fell, and weak investment in agriculture and industry indicated decreased investor confidence in the local economy. In other words, the increase in Lebanese exports was largely due to the deterioration of the Syrian economy. Lebanon's trade deficit widened by 5.7 percent of GDP in 2012 and the country recorded a $1.5 billion balance of payments deficit.[7]

Lebanon's financial sector, historically a pillar of stability, has performed relatively well during the Syrian crisis. Although banking profits have suffered somewhat, loans and deposits have continued to grow. Lebanese banks operating in Syria were exposed to falling asset values, rising risks of default, and a weakening Syrian currency, but exposure had a limited effect on their overall performance, and has since shrunk significantly. Additionally, instability in Syria or Lebanon has not led to pressure on the Lebanese pound, or compelled the BDL to draw on its sizable foreign or gold reserves (BDL

6 "Hariri, Economic Committees Say Lebanon Should Remain Neutral," *The Daily Star*.

7 "Lebanon Economic Report," *Bank Audi*.

was actually a net buyer of US dollars in 2012).[8] Lebanese banks still see lending to the state as an easy and relatively secure investment.

However, the government's fiscal problems are growing and banks have begun to express concern over deteriorating public finances. With the fiscal deficit at around 8 percent of GDP, heavy pressure from organized labor for a public wage increase in a weakening economy threatens to further strain public finances and increase inflation, which measured 10 percent in 2012. Although not directly related to instability in Syria, the Syrian crisis caused a wider economic slowdown that magnifies the challenge of the wage issue. Lebanon saw weeks of public sectors strikes in early 2013 that paralyzed parts of the bureaucracy. With its growing fiscal deficit and enormous debt burden, it is unclear how the state will fund a 35 percent public sector wage hike—which the cabinet approved in March 2013 and could cost some $1.2 billion—without resorting to higher taxes, spending cuts, or widening the deficit even more.[9]

Perhaps the most dramatic effect that the Syrian conflict has had on Lebanon is the influx of hundreds of thousands of Syrian refugees. This brought the total number of Syrians in Lebanon to around 1 million, including some half a million workers and 495,000 refugees as of May 2013. While this increased the demand for low- and middle-income housing and boosted the rental market, it harmed local residents struggling to meet the cost of housing. Furthermore, refugees' willingness to work for low pay has depressed wages and worsened unemployment for Lebanese. Many areas with high refugee populations, especially northern Lebanon and the Bekaa Valley, were very poor before the Syrian war broke out and are not equipped to cope with even greater economic hardship.

Although lower-income refugees have not been settled in state-funded refugee camps, their needs still place a heavy burden on public finances. Sources close to former prime minister Najib Mikati estimated that the state requires around $370 million to support refugees, and has already spent some $140 million. However, there is a great deal of hesitancy among the political elite to help the mostly Sunni Syrian refugees settle in Lebanon, which would aggravate sectarian tensions and upset the country's delicate demographic balance. The government will probably continue to try to shift responsibility of providing for refugees onto the international community, but the longer fighting in Syria persists, the more pressure on the government will grow to commit resources to the refugee problem. The state does not have these resources however, and is unable to create jobs and provide basic services for much of its own population.

The Syrian crisis' impact on Lebanon's economy through the standard channels of trade in goods and services and financial flows has therefore been negative, but not catastrophic. The real economic danger that the war in Syria poses lies in its deep political implications for Lebanon. As each side tries to out-maneuver the other ahead of the anticipated collapse of the Syrian regime, political infighting will paralyze economic reform. The Hezbollah-led faction is much less concerned with domestic policy than it is with retaining its military posture against Israel and ensuring that the Syrian regime defeats the rebellion. Its opponents on the other hand see no need to cooperate over policymaking with Hezbollah, whom they believe will soon be weakened with the loss of its Syrian ally. Much of the escalating political infighting between Lebanese factions is ultimately about the fate of Syria and how this impacts Lebanon, even as it takes the form of bickering over the electoral law and other domestic issues. Infrastructure development, privatization in telecommunications and the power utility, and implementing much-needed fiscal and administrative reforms will be very difficult in the current politically polarized environment.

Economic Outlook for Lebanon

The disintegration of Syria is undermining the delicate sectarian compromise that made possible a semblance of peace and economic stability in Lebanon after its civil war ended in 1990. Deepening suspicion and hostility among the Lebanese themselves and competition for resources with a growing refugee population are destroying what little is left of civic communalism and trust in public institutions, which have become paralyzed as a result of political deadlock. This is hardly conducive to economic growth and prosperity, even if events in Syria do not plunge Lebanon into full-blown civil war.

8 Ibid.

9 "Lebanon's Plan to Raise Public Pay Dismays Finance Minister," *Reuters*, March 22, 2013, **http://www.reuters.com/article/2013/03/22/lebanon-strike-idUSL6N0CE7R820130322**.

Mikati's March 22 resignation followed a disagreement with the Hezbollah-led governing coalition over an electoral law and the extension of the anti-Hezbollah police chief's mandate. These issues can only be understood in the context of the Syrian crisis, which has left Hezbollah feeling vulnerable due to the threat to its Syrian patrons, and worried about possibly losing parliamentary elections under the existing electoral law.

Lebanese factions have yet to agree on an electoral law ahead of parliamentary elections originally scheduled for June 2013 but now postponed until November 2014, or to form a cabinet following the resignation of Mikati. This has left government in the hands of a caretaker cabinet with a limited mandate. Lebanon now faces the real prospect of going without a functioning cabinet in the face of growing labor unrest, worsening public finances, a crisis in its key economic sectors, and deteriorating security along and within its borders. This is likely to further undermine foreign and domestic confidence in the economy, even in the absence of all-out fighting among rival factions, which itself is increasingly likely.

Real estate, industry, agriculture, and FDI are all at risk, as are exports to and through Syria. Even the banking sector will find itself increasingly vulnerable given the state's finances and its weakening ability to service its debt. The government has launched a $1.46 billion stimulus package aimed at spurring bank lending to consumers, but it is targeted overwhelmingly at the real estate sector and may have no effect in this risk-averse environment. The stimulus package indicates a slight but important shift in the central bank's conservative attitude and practices, reflecting its worries about the economy. It also demonstrates the role of the financial sector as the main engine of growth, and that the central bank has been more active in economic policymaking than the government.

The absence of a Lebanese cabinet does not by itself spell economic disaster. In the past, Lebanon has muddled through without a cabinet, president, or functioning parliament for months at a time without triggering an economic crisis. It is the convergence of external and internal political and economic factors, combined with deteriorating security, that are especially worrying for the economy. Unlike previous crises in 2005-10, when Saudi Arabia, Iran, and Syria cooperated to broker power-sharing agreements among their allies in Lebanon, now Saudi Arabia and Iran are fighting a de facto proxy war in Syria. The externally-brokered temporary compromises that allowed economic growth to be maintained in Lebanon's past are not likely to materialize in the present or in the near term.

As for the Lebanese factions themselves, they appear unwilling or unable to reach a political compromise that would allow for even limited economic reforms, much less fundamental shifts such as pursuing more inclusive economic development outside the capital and strengthening the productive sectors. There is little sense of urgency over the economy in political circles, and apparently little concern that Syria's troubles will harm the wellbeing and prosperity of Lebanese from all sects and factions. The political class seems to have adopted a wait-and-see approach to the outcome of fighting in Syria, concentrating on securing their political and security interests, and in general treating the economy and public policy as an afterthought.

Political Implications Inside Lebanon

The interplay between Lebanon's political dysfunction and Syria's civil war poses the most serious threat to the Lebanese economy. Economic policy and reform is in the hands of the country's deeply sectarian political elite. This is worrying because it places responsibility for protecting economic stability on a political class that is not overly concerned with the economy. Lebanon's factions need to approach the crisis in its political institutions with greater urgency. It is unrealistic to expect significant progress in privatization and fighting corruption, genuine neutrality toward the conflict in Syria, or a grand compromise over wider sectarian issues. Although any of these would have a positive impact on the economy, they are not achievable absent a strong and very unlikely political consensus.

Instead, political rivals should at least form a national unity cabinet with minimum delay. It is true that a unity government would give key factions veto power over cabinet decisions, and would therefore be unable to take decisions on contentious political issues. Still, a weak government is better for investor and consumer confidence and the economy than no government at all. It would at least signal an intention to compromise in the interest of economic stability. Besides, if Lebanese politicians believe the intractable issues dividing them cannot be resolved until the Syrian conflict draws to a close, then there is little point in sabotaging such an uncontroversial agenda as responsible economic and financial management. It would be better for Lebanon's politicians to fix what they can, and let events in Syria decide the larger issues. In the meantime, in order to help alleviate financial pressure on the state the international community can provide funding and other assistance to help with the worrying refugee crisis, and support development efforts in Lebanon's poorer regions and communities.

Lebanon's success over the last two decades in avoiding economic collapse despite repeated domestic and regional crises has bred a sense of complacency about the economy among the political elite. The danger is that political leaders may fail to recognize that the Syrian crisis is a threat of a very different type and magnitude than occasional short wars between Hezbollah and Israel and the sporadic unrest to which Lebanon has become accustomed. The Syrian war poses a danger to the foundations of the modern sectarian Lebanese state. However weak and dysfunctional the Lebanese state might be, it is critical to economic stability, and Lebanon's politicians will need to radically revise their policy priorities if they are to protect either.

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