

II — EMERGING FACTORS AFFECTING LEBANON'S POTENTIAL AS INTERNATIONAL FINANCIAL CENTER

A — CAPITAL OUTFLOW FROM THE OIL EXPORTING COUNTRIES

By far the most important single development affecting the prospect of promoting Lebanon's role as an international financial center has been the enormous increase in revenues which the Arab oil exporting countries have been realizing, particularly since October 1973.

It would be unnecessary here to engage in the unsure exercise of estimating the current and future oil revenues and surplus of the Arab countries. Recent estimates for the 1974 oil revenues of the Arab countries as a group have varied between \$ 60 billion and \$ 75 billion. Forecasts for the years to come can only be much less certain, as the actual results will depend largely on the general supply and demand conditions of the petroleum industry in the world, which in turn will depend on such a large diversity of factors as the size of proven oil reserves, the development of substitutes or competing sources of energy, the structure of the supply market, economic developments in the consuming countries, etc. The Arab countries' share in the total revenues will depend on developments affecting their agreements with the oil companies and the sharing arrangements they reach with them. Obviously it would be virtually impossible to predict the behaviour of all these factors with any degree of certainty. Yet various predictions have been ventured, placing the Arab countries' total oil revenues in 1980 at \$ 100-130 billion.

If there is so much uncertainty engulfing forecasts of oil revenues, there is bound to be even more uncertainty surrounding forecasts of the capital surpluses which will be available for export to the various financial centers of the world. For this will depend on such equally uncertain determinants as the future absorptive capacity of the oil producing countries themselves and of the other countries which seem to be attracting a growing flow of Arab investment funds, namely the Arab capital importing

countries and the rest of the developing world.

Apart from all the preceding considerations, the size of the financial flows which will find their way from the oil-exporting countries to the various financial centers of the world will be influenced by the outcome of the « current efforts by governments and multilateral agencies such as the International Monetary Fund and the World Bank to arrange the recycling of oil revenues through the public rather than the private sector. It is possible to envisage a situation where the entire aggregate oil deficit of the industrialised and developing countries might be financed outside the private sector Euromarket » (1). The recent establishment of the Oil Facility at the International Monetary Fund illustrates the kind of action that might be taken in that direction.

Irrespective of the exact size of the prospective surplus, however, it will probably be of a magnitude which foretells of a potentially substantial role for Lebanon as an international financial center.

If Lebanon is to develop its financial market so as to cater on a substantial scale for the Arab capital export surplus, the nature and structure of the market will have to be conditioned by the special features and requirements of that surplus. Three main considerations seem to be of paramount importance in this respect :

1 — The first is that the bulk of the oil revenues will accrue to the Arab governments. Consequently the supply side of the market will be characterized by a relatively high degree of concentration. This implies that Lebanon's role as a financial center shall have to be designed, on the one hand, to accommodate the particular demands of those few suppliers and, on the other hand, to answer to the possible advent of monopolistic practices. It would not be unlikely for the capital exporting countries — in fact from their points of view it might be desirable — in their pursuit to coordinate their investment policies to coalesce financially as they have so effectively done through OPEC on questions related to oil production and marketing. In a financial market,

(1) Mary Campbell, « A World-Wide Market Now », *the Financial Times*, March 4, 1974, p. 13.

a high degree of concentration on the supply side would obviously create a situation which is fraught with the dangers of latent instability. To the banks such latent instability will compel the banks to maintain unusually high liquidity ratios, to the detriment of their competitiveness with the larger banking institutions in other financial centers.

It should be admitted, however, that the situation is somewhat tempered by three main factors, namely :

a) The extent to which the oil revenues initially accruing to governments will eventually trickle to the private sector, and this depends in large measure on the nature and size of domestic development expenditures in the various oil exporting countries.

b) The tendency of control over the Arab governments' financial resources to be divided through the creation of specialized, autonomous organisms, often with private sector participation. The Kuwait Fund for Arab Economic Development and the Abu Dhabi Fund for Arab Economic Development are examples of governmental agencies for the investment of an allocated portion of the oil money for a set purpose. The Arab Fund for Economic and Social Development and the embryonic Islamic Development Bank, the Arab Bank for Economic Development in Africa, and the Arab Investment Company are examples of inter-governmental ventures set up for similar purposes. The Kuwait Investment Company, the Foreign Trading Contracting and Investment Company of Kuwait, and the Industrial Bank of Kuwait are examples of joint ventures between the government and the private sector.

c) The very investment activities undertaken, whether directly or indirectly, by the governments of the oil exporting countries in foreign markets would naturally entail transfer of control over the funds invested, for some time at least, to the hands of their recipients.

Notwithstanding the foregoing attenuating factors, however, the rein of control of a major segment of the petro-funds will remain in the grip of a few governments.

2 — The second consideration is the fact that the Arab oil countries' investment policies are becoming increasingly swayed, and rightly so, by their awareness that oil is a depletive asset. A

corollary of this consideration is the view that oil production — to the extent that it is carried out at higher levels than is necessary to meet the oil countries' current revenue requirements — is tantamount to a process of liquifying a wasting asset which may alternatively be kept underground. For the oil exporting countries it would be justifiable to permit, in deference to the consumer countries' demands, high rates of production only if the resultant financial resources are assured of equal safeguards from the attribution of currency devaluations and inflation as are the oil reserves if left underground (1).

Apparently this position has given birth to a distinct investment strategy whose most salient features include :

a) A preference for short term placements which would allow the capital exporting countries a minimum leeway of manoeuvrability (through quick switch-overs between currencies and investment outlets) in seeking to avert impending currency risks and to realize a fair rate of return.

b) An increasing interest in direct investments in real estate and industrial equities in the developed world. Presumably these channels of investment tend to provide a measure of security vis-a-vis the dangers of inflation. As they involve investments in real assets rather than merely in financial claims, these channels may provide the long term answer to the oil countries' concern about their loss of a vital depletive asset.

c) A growing interest in denominating financial claims in the oil countries' own currencies. This, besides the oil countries' genuine interest in contributing to the development of the third world, partly explains the growing tendency to supply the developing countries with loans denominated in the oil countries' own currencies (2).

(1) See lectures by Abdelatif Y. Al Hamad : « Arab Capital and International Finance », November 1973, « Arab Funds and International Economic Cooperation », November 1973 ; « Oil, Oil revenues, and the World Economy », March 1974 ; « Investing Surplus Oil Revenues », April 1974, all published by Kuwait Fund for Arab Economic Development.

(2) See author's article on « Developing Longer Term Channels For Arab Oil Money », *Euromoney*, October 1974.

3 — The third and final consideration is that the Arab capital exporting countries have over the years established their direct channels with the international money and capital markets of the world. Thus if Lebanon is to capture a fair portion of the Arab capital export surplus, the Lebanese market will have to match, not to say excel, the other old-established markets in the efficiency with which the Arab Funds are handled in at least some lines of investment activity.

B — THE CHALLENGE OF OTHER EMERGING FINANCIAL CENTERS IN THE REGION

Various countries in the region will endeavour to develop their own financial markets. We have no intention here to discuss and evaluate the prospects of various potential markets in the region. This would carry us too far afield. A brief reference to the situation of the potentially more important ones among them, however, will be in order.

Among the capital exporting countries Kuwait apparently pauses as an immediate and serious candidate, followed perhaps by Dubai or Bahrain. Kuwait has at least two main points in its favour :

One is the fact that Kuwait has been and will remain to be in the foreseeable future a very important source of capital exports in its own right. To demonstrate Kuwait's growing capital export capability, it is sufficient to state that, whereas its oil revenues amounted to only \$ 717 million in 1967, they increased to \$ 1657 million in 1972, and are projected at \$ 8000 to \$ 9000 million in 1974.

The second point in Kuwait's favour is the store of expertise and experience that it has had the chance to build and the extensive contacts that it has been able to cultivate with the various financial centers of the world, particularly since the early 1960's. Now Kuwait has virtually attained a stage where some of its institutions can handle sums of investment funds with an impressive degree of professionalism.

Apparently Kuwait's interest in promoting its own position as an international financial center stems partly from the

fact that it has already been successful in achieving a substantial headway on the road to financial development which it might as well capitalize on, and partly from the fact that the development of an international financial market would provide a welcome source of national income in an economy which has been over-dependent on a single commodity, i.e. oil, and for which output diversification has understandably become an avowed top-priority target.

Kuwait is likely to succeed in further developing its financial sector, and the growth of its financial market will probably be at least commensurate with the growth of its capital export potential. Whether Kuwait, however, will succeed in developing a full-fledged international financial center or merely a capital export market remains to be seen. Kuwait's prospects will be seriously handicapped by the official policy in application, which bars Kuwait's financial market completely to foreign competition.

In any case, Kuwait's and Lebanon's markets may conceivably evolve along complementary rather than competitive lines. Lebanon might well serve as a retail outlet for the investment funds flowing out of Kuwait and, for that matter, of other capital exporting countries in the region. The high degree of concentration characterizing the Kuwait financial market and the markets of other capital exporting countries, and the very size of their capital export surplus may help to generate a bias in those markets favouring wholesale finance.

Apart from the capital exporting countries, some capital importing countries aspire to promoting their own financial markets. Egypt is a particular case in point.

Under the liberalization policy Egypt has lately adopted attempts are being made to encourage the entry of foreign banks into the free zones recently established, and serious consideration is being given to the possibility of allowing foreign banks into joint ventures with local institutions inside the domestic market.

Egypt may very well succeed in creating an active financial market that caters primarily for Egypt's own local and foreign requirements. Whether it will succeed in posing a serious challenge to Lebanon's prospective role as a financial entrepot is

another matter. Lebanon enjoys the precious advantage of having a record of demonstrable stability in its systems, policies and regulations ; and a dynamic, resilient, and relatively large banking sector on which a full-fledged financial market may be superposed.

In any case, even if Egypt succeeds in developing an international financial center of its own, Lebanon should seek to develop the areas of complementarity with it, as it is supposed to do with all the financial markets that might emerge in the Arab region.

C — ECONOMIC LIBERALIZATION AND INVESTMENT OPPORTUNITIES IN THE CAPITAL IMPORTING COUNTRIES

The economic liberalization moves recently initiated by some of the capital importing countries, notably Egypt and Syria, are likely to stimulate vast new investment opportunities in those countries which Lebanon's financial market will be called upon to accomodate.

Much of the investment activity which may be undertaken in those countries will probably be government sponsored. The new liberalization moves, though, are directed in large measure at stimulating private initiative. Thus any financial center in the region, as Lebanon aspires to becoming, will have to accomodate the requirements of both governmental and private-enterprise projects. The prospect is that the governments will probably put up a much larger front in the coming few years.

The region has belatedly witnessed a veritable invasion from the major international banks. In some of the countries of the region these bankers are finding themselves up against a challenge as they discover that their role as sheer financiers will be highly ineffectual. They will be called upon to perform some of the functions ordinarily identifiable with investment promotion, investment banking, and merchant banking. The paramount needs of the region lie in identifying investment opportunities and evaluating them, in preparing for the implementation of pro-

jects, and in like activities. Finance comes as a complementary aspect.

It is noteworthy that this is neither peculiar to the Middle East nor completely alien to the big banks. In fact the big banks have for years been developing their capabilities in this direction. Competition in the Euro-markets has already forced a radical shift in approach among them from balance-sheet financing to project financing (1). One might also expect that merchant banks will have a particular role to play in the Middle East, as they have started to play in Singapore, where, between 1970 and 1973, 16 merchant banks have been established with British, European, American, and Australian interests (2).

In connection with the roles that a financial center will have to perform in financing investment activity in the capital importing countries of the Middle East, a question may be raised as to the non-commercial risks to which such a center will be exposed.

The Arab Investment Insurance Company which was recently established in Kuwait is designed to provide cover against such risks. Its resources, however, are too meager to allow it to play a very affective role in this respect.

It may be maintained that in the final analysis the real assurance against non-commercial risks lies, on the one hand, in the healthy economic atmosphere that rapid development is likely to engender and, on the other hand, in the very prospect of a continuous flow of funds which sets a high premium on credit worthiness. No capital importing country can afford to alienate a formidable source of investment funds.

D — CHANGING CHARACTER OF THE BANKING SYSTEM OF LEBANON

Three main phenomena affecting the banking system are relevant to mention, namely the growing foreign presence, the in-

1: William Hall, « Funds for Massive Projects », *The Financial Times*, March 4, 1974, p. 18.

2: Soh Tiang Kang, « Singapore : Growing Sophistication in the Financial Community », *The Financial Times*, October 1973, p. 20.

creasing number of medium and long-term credit banks, and the imminent introduction of a « banking free zone ».

The dominant position of the foreign banks has perhaps always been the most striking feature of the banking system of Lebanon. In 1945 there were only nine full-fledged banks in the country, of which five were foreign and one was locally incorporated under non-Lebanese Arab control. On the eve of the Intra crash in 1966 there were 90 banks, of which 60 could be classified as Lebanese and the rest were either foreign banks (incorporated outside Lebanon) or jointly-held banks (incorporated in Lebanon with a significant, often controlling, foreign interest in their capital). The latter group of foreign and jointly held banks accounted at the time for 63 percent of the total deposits in the country. By the end of 1968 the number of banks had dropped to 73, of which only 34 could be classified purely or predominantly as Lebanese. Now out of a total of 73 commercial banks only 29 banks can be identified as Lebanese. In the last few years a number of formerly locally-held banks have slipped into foreign hands by acquisition.

The all too pervasive foreign presence in the banking system calls for two main observations. In the first place, in relation to the potential role that Lebanon is hoped to play in the financial life of the Arab Middle East, the Arab presence in Lebanon's banking system seems to be still unduly weak. Of the oil exporting countries, Saudi Arabia, Kuwait, Libya, and Iraq have financial bridge-heads in Lebanon by way of branches or subsidiaries of banks based in those countries. In terms of volume of operations conducted in or through Lebanon, the relative impact of those institutions seems to be still conspicuously weak. Besides, other important capital suppliers — notably the remaining Gulf states — are still not represented in the Lebanese market.

In the second place, the advisability of allowing such a vital sector of the economy as banking to pass over to foreign hands is questionable. The possible adverse implications that this development may have with respect to the total availability and distribution of bank credit in the economy and with respect to the authorities' control over the monetary conditions in the country are often cited as possible negative consequences.

It is expected that the character of banking in Lebanon will

be significantly affected by the imminent introduction of « a banking free zone ». The flow of foreign funds into Lebanon's banking system has been seriously hampered by the existence of three levies on all deposits : namely a 10 percent tax on interest (from which only savings accounts are exempted), a mandatory reserve requirement, now at the rate of 8 percent, and a 1.5 per mil deposit insurance fee.

The Council of Ministers has recently approved a draft law providing for the exemption of the foreign-currency deposits of non-residents from all the foregoing three levies under a formula which has been conveniently labelled as « banking free zone ». It is anticipated that this will provide a momentous boost to the flow of foreign funds into and through the banking system of Lebanon. It may eventually induce a vast expansion in the foreign exchange market and may, in the process, give birth to an « Arab dollar » market paralleling the Euro-dollar and Singapore's Asian dollar markets.

The reserve requirement on all foreign-currency deposits was recently reduced to 5 percent and subsequently to 4 percent, and is due to be phased out completely by the end of the current year. It should be recognized, however, that this would not obviate the need for a « banking free zone ». The abolition of the reserve requirement on all foreign-currency deposits has been dictated by transient monetary conditions. This action is apt to be reversed if and when the situation changes.

Banking activity is also being influenced by the inroads of new types of institutions. There are now three medium and long term credit banks in operation, two others are under formation, and a few more seem to be in the offing. The National Bank for Industrial and Touristic Development has also been recently established as a joint venture between the Government and the banking system. Besides, three new finance companies have recently been set up, one as a joint venture between Lebanese, Arab, and foreign interests and the other two virtually as subsidiaries of foreign companies.

E — CONCLUDING REMARKS

It will be possible for Lebanon to develop its role as an international financial center by building on a fairly developed banking system which is marked by a high dosage of foreign presence and an increasingly distinct international perspective.

The banking free zone proposition is apt to provide a considerable boost to the banking system's international role and image, and should thus be regarded as an essential ingredient of any plan to develop Lebanon's position as an international financial center. An Arab dollar market, which may prove to be a vital aspect of the prospective financial center in Lebanon, may be expected to emerge as an offshoot of the banking free zone proposition.

Because an internationally oriented financial market in Lebanon will inevitably be heavily dependent on the Arab sources of funds, its prospective features may be expected to mirror the requirements and trends of the flow of Arab oil money. The following features are foreseeable :

The market has to deal in both short term as well as long term funds. In view of the fact that the petro-funds' present preference is still predominantly in favour of short term investments, Lebanon's market should be equipped to properly accommodate this preference. The banking system will naturally be called upon to perform a particular role in this domain.

On the other hand, given the increasingly discernible shift on the part of the Arab capital exporting countries in favour of financing development in the third world and in favour of direct investments in real estate and equities in the industrial world, Lebanon's financial market can keep up its projected role only if it succeeds in developing its own instruments and channels of international long term investment.

The function which financial institutions will be called upon to discharge in the Middle East is likely to involve such activities as are ordinarily identified with investment promotion, investment banking, or merchant banking, including identification and evaluation of investment opportunities.

The market should be prepared and equipped to deal in

the reserve currencies, the various Euro-currencies, and the Arab currencies themselves. It is also conceivable that an Arab unit of account, an « Arab dinar », may be introduced in the future for use in international transactions.

The financial market of Lebanon should be sufficiently resilient as to be open to frequent innovations. The far-reaching changes that have beset the international financial scene in the last few years serve to underline the fact that only a dynamic and adaptable market can possibly survive. The legal and institutional framework of the market should be flexible enough to allow for the adoption of new practices, techniques, instruments, and institutional formulas in response to an ever-changing situation.

The following quotation relative to the City of London is relevant in this connection :

« There is one more characteristic that I believe a first-rank international financial center should possess — adaptability. London has been especially quick to meet the demands of new conditions... There is a strong trend for the London-based banks continually to widen the range of their banking activities and develop new monetary instruments » (1).