The Relationship Between Economic Development and the Health of the Financial System in Emerging Economies: The Case of Lebanon

Mohamad Abou El Hassan[1]
[1] *The Bucharest University of Economic Studies, Bucharest, Romania.*
E-mail: abouelhassanmj@hotmail.com

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Abstract

After several decades of continuous geopolitical and financial instabilities, the Lebanese financial system and mainly its banking sector was one of few financial systems that could withstand many local, regional, and international crises. On the other hand, the incremental cost of borrowing led to over burden the capital structure of the Lebanese Republic that designated the indirect beneficiary of the liquidity supplied by highly concentrated stakes in the banking system in form of various types of deposits that were allocated by different Lebanese governments for financing the development and construction processes of the country after decades of continuous war massive destruction. Consequently, the adoption of modern strategies for reducing cost of fund and for reinventing the whole Lebanese financial system including its various economic sectors became a must while considering the education the Lebanese investors to assume new investment approaches that could be of their pretentious benefits.

The main objective of this research is to emphasize the necessity of leading the Lebanese economy with all its industries and sectors towards adopting a scientific and well-structured reform and towards interpreting new sources for financing the economic development and industrial activities rather than depending on the banking sector solely for this purpose. Despite the lack of references and disclosed studies about the Lebanese Financial System, the methodology of research and investigation in this study evolves from analyzing the core economic indices and figures of the Lebanese economy. The analysis shall involve the impact on the performance of the financial system and the banking sector by reviewing and analyzing the official reports disclosed by the correspondent entities. Furthermore, it will assume analyzing the approaches and financial models adopted by a selected sample of the highly ranked/alpha banks operating in Lebanon during the period of political, security and economic stability between the year 2011 and 2015.

The demonstration through this research will emphasize the essential role of the banks in supporting and developing emerging and developing economies, namely in the case of Lebanon. The findings are to demonstrate through theoretical and descriptive argumentations and technical simulations the necessities emerged to innovate, structure, and introduce new investments alternatives by activating the domestic capital and money markets. The results show that the banks in Lebanon are in front a surging need to start thinking of recrafting new business models by inventing modern financial investment strategies that suits their clientele and the industry simultaneously.

Keywords

Lebanon; economy; banks; finance; market.

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Introduction

This research paper was prepared to cover fundamental and technical areas of research study and to interpret the relation between the healthiness of financial system in emerging economies in relation to economic development. The paper aims at covering the study of micro and macro aspects of the economy of Lebanon and its financial system. The problematic in this research study evolves from the need of linking the correlation of benchmarks of economic key performance indicators (KPIs) in a certain emerging economy to the steadiness, stability and healthiness of the correspondent financial environment and its related monetary and fiscal policies as well as the adopted practices of micro and macro investment across all the domestic economic sectors.

The study will refer to all the key players being the legal bodies, regulatory parties, investment industry stakeholders, economic sectors, investment, commercial and retail banks as well as investors. The major analytical correspondences will investigate the necessity of launching and accommodating for the reform and for the transitional phases that are recommended for adoption by all the key players by targeting the findings and recommendations of this research paper.

The core problematic of this paper evolves from several fundamental facts that are adding heavy burdens and barriers against the development of the Lebanese financial and economic sectors (Kankeu et al., 2013; Sumpf, Isaila & Najjar, 2016). The controversy and the dilemma subject of this research study were initially identified by the key facts derived from the highly corrupted and deteriorating economy (Dibeh, Fakih & Marrouch, 2018), the suffering economic sectors in spite of the growth of banking sector that embeds high concentration customers' deposits in the banking sector in which it involves many direct and indirect types of exposures of different risks (Awdeh & Hamadi, 2018).

The concentration of funds has been bearing an advantage for the Lebanese commercial banks designated in collecting easy profits generated from the reinvestment opportunities in the Lebanese public debt. However, the private sector industries remained suffering from the lack of resources and offerings for raising funds. Consequently, they were directed to depend on the shelters of indebtedness secured by the banks for financing their expansion and operational duties at premium to those risk-free rates that the government had been servicing its debt at.

The study then will aim to illustrate the national, regional, and global financial challenges and opportunities especially those related to the investment behaviors and the allocation of capitals along with the economic incentives granted by governments in the form of interest rate that are currently ticking at negative yields in well-developed and leading economies. The latter economies maintain universally recognized legal frameworks and controls that organize the essential roles of stock exchanges, banks, and other financial institutions.

Having this vast of legal organization and economic development, the developed countries facilitate and encourage their economic sectors to get publicly listed for trading on the exchanges so that to encourage raising funds, boost liquidity, decrease cost of borrowing and creating investments opportunities. The arguments for these actions are connected to stimulating investments (Dima, 2021), facilitating new business development (Trifu et al., 2014) that stimulates local industry to become more competitive (Dima, 2018). In this context, while the development reached the majority of the world economies and financial industries, the Lebanese financial investment industry remained closed with very shy public listings where the whole public and private sectors were left to their destiny to depend on the banking sector for financing their investment, debt, and commercial activities.

This study aims to cover through several fundamental and technical approaches the necessity of opening the Lebanese financial investment markets and to encourage the Lebanese corporations to get publicly listed and to start issuing their own financial papers for financing their commercial activities. Moreover, the study will investigate the advantages and the incentives that the Lebanese banks would remain enjoying even if the capitals were routed towards financing the other public and private economic sectors. Nonetheless, the research will also aim at demonstrating the advantages that would be announced for boosting the whole national economy by enhancing employment rates, balance of payments, increasing GDP, decreasing public debt, attracting foreign investments and capitals, increasing the reserve in foreign currency, lowering cost of debt service, and borrowing, decreasing the level of associated risks whilst complying with the international benchmarks, best practices, recommendations and

The paper will review, investigate, and refer to publicly disclosed and referenced sources from Lebanese local, regional, and international sources so that to illustrate and demonstrate the findings and the recommendations.

1. The Lebanese economic standing and debt breakdown

After the civil war, Lebanon was left alone with many dramatic challenges on all levels especially those related to its economy and finances (Vrontis et al., 2019). Lebanon major concern was to raise the needed funds and capitals for financing the process of the reconstruction and to secure the ways of sustaining and stabilizing the economic and financial factors associated with the local currency fluctuation by reestablishing the value of the Lebanese currency. Consequently, Lebanon found itself forced to depend on local and Eurobond issuances in the domestic and the European markets throughout issuing treasury bills that caused the rise in the level of both foreign and domestic indebtedness. The process of raising the needed funds and capitals was mainly managed by the central bank beside the contributions that were channeled from the Arab and the international communities through the local banks after adopting the pegging policy of the local currency against the U.S. Dollar at an average rate of 1$/1,507LBP.

The Lebanese local banks, that are family established, founded, and owned, enjoyed advantageous opportunities of adding their secure profitable premiums on all the attracted funds for investment in the Lebanese economy by managing the process of facilitating the process of subscription to the Lebanese public debt. In fact, the Lebanese banks contributed by attracting the local, regional, and international institutional, and retail high, medium and small size placements by structuring relative banking investment schemes and products for investment purposes that were all sponsored by the high returns secured by the country's courteous debt service levels. The attracted capitals were invested in form of deposits with the banks that were later reinvested in the Lebanese Republic public debt.

On the other hand, the casual instability at the levels of security, politics and economy has left the Lebanese industries suffering from allocating the needed sources of funds for recovery after decades of war and regional destruction. Beside a deteriorating legal framework and because of the highly corrupted political regime, the financial sector, that cannot function without abiding by the international financial standards and best practices of compliance, transparency, and disclosure, found itself paralyzed in front of securing the required funds, attracting new investments, and maintaining a trustful environment for the existing businesses to sustain.

The key basic services that Lebanon lags behind are electricity, safe water, sanitation, telecommunication, and transportation. These services are not only essential for the growth in productivity and income, but also for ensuring a basic level of living standard for the citizens. When the latter services effectively provided along with a stable environment, they can be reflecting a positive impact on income fairness by allowing low-income groups to have the access to better and courteous opportunities.

Moreover, the degraded bad level of basic services led to regressive consequences on the social, moral, educational, and legal for all the economic classes. It also led to deteriorate the social bonds between the citizens and to increase the level of legal corruption that be reflected on the increase in the levels of crimes and fairness. Also, it would lead to widening the gap between the social classes with the effect of diminishing the middle class to the favor of the lower classes in which corresponds to higher poverty, exhaustion, and suffering.

Referring to the report issued by the Lebanese Ministry of Finance, Debt and Debt Markets, Issue No. 51, Q4, 2015, the following figures can be concluded about the performance of the regulating bodies, the government, and the economic status of the Lebanese nation. For instance, between the years 2007 and 2015:

– The overall debt grew from LBP 63,364 billion (USD 42.3Bn) to reach LBP 105,994 billion (USD (70.66). Representing about 167% as a growth rate in debt. Out of which:

– The public debt denominated in local currency grew from LBP 31,373 billion (USD 20.92 Bn) to reach LBP 65,195 billion (USD 43.46). Representing about 208% as a growth rate in local debt in Local currency;

– More than 90% of the public debt denominated in local currency is held by the local commercial banks and the central bank combined. 63% of the public debt is held by the local commercial banks and 37% of the public debt is held by the Central Bank;

– The public debt denominated in foreign currency (EURO-Debt) grew from LBP 30,991 billion (USD 21.32) to reach LBP 40,799 (USD 27.20) Billion. Representing 128% as a growth rate in local debt in foreign currency. 92% of local debt denominated in foreign currency is in the form of Eurobond.

"Moody's considered that reliance on domestic debt to finance budget deficit is expensive and it can adversely affect the balance of payment flows and foreign currency reserves. As fiscal deficit remains high, public debt is increasing at an annual average between $4 billion and $5 billion if the increase in spending is continuous. The burden of higher debt is felt through the debt service and the situation may worsen with any hike in global interest rates. In the recent past, high growth and low global interest rates have helped to lower the country's debt burden according to the IMF's report, 'Concluding Statement of the 2015 Article IV Mission'. But the same report warned that global and domestic conditions will be less favorable in the foreseeable future and without adjustment, public debt will continue to increase. The report said that interest rates will inevitable rise along with global rates. Citi research forecasted that public debt would be 149 percent of the GDP, equivalent to its 2015, but much more that in 2014 (143 percent) or four years ago (133 percent)" (Lebanon Opportunities, 2016).

"High indebtedness has been plaguing the Lebanese economy over the past two decades or so, as the government has been caught in a vicious cycle of a hefty public debt burden and recurrent budget deficits. This has thwarted the economic growth, escalated the debt crisis, and positioned Lebanon among nations with the highest debt to GDP ratios in the world." (Credit Libanais Bank, 2016).

"External Debt in Lebanon increased to 29877.90 USD Million in April from 29873.30 USD Million in March of 2017. External Debt in Lebanon averaged 15116.05 USD Million from 1993 until 2017, reaching an all-time high of 29877.90 USD Million in April of 2017 and a record low of 315 USD Million in July of 1994. External Debt in Lebanon is reported by the Ministry of Finance, Republic of Lebanon." (Ministry of Finance, Republic of Lebanon, 2016).

On the other hand, the interest rates disclosed by the FED to be in the United States are showing some optimistic exertion with bullish projection and expectations towards an attained increase that reached 2.50% currently. Consequently, it is worth taking into consideration that about 93% of the Lebanese debt in foreign currencies is denominated in the US Dollars (Ministry of Finance, 2016). Accordingly, this factor would necessitate an upward driven impact on the interest rates in Lebanon so that to reach another all-time high over a decade.

The deposit dollarization ratio registered a slight increase, reaching 65.8% while the loan dollarization ratio continued its downward trend to reach 72% at end-2016, its lowest recorded so far (Central Bank of Lebanon, 2016). Accordingly, deposits in USD are about reaching the edge of USD 90 Billion to constitute about 190% of Lebanon GDP that reached by the end of 2016 USD 47.6 Billions. All the precedent indicators lead to demonstrate the depth, the strength, the level of dependence and the direct correlation in the relationship between the Lebanese pound and the Dollar base currency. Accordingly, this indicator also implicates the level of correlation between the interest return on the deposits denominated in USD versus those in LBP.

"The dollar tends to depress the values of emerging market currencies at a time when many EM economies are already weakening and their currencies have already slumped against the greenback. However, many analysts and fund managers expect the greenback to continue to climb higher in the coming years, as the Fed raises interest rates further …An upward move in short-term interest rates will be positive for savers who have been missing out on interest on their deposits" (Financial Times, 2016).

All the precedent demonstrated facts constitute major reasons for causing the incremental trends in increasing the interest burdens on the local public debt. More, the depositors with their placements with the banks in Lebanon transformed the banks into being the main suppliers of the public debt have been granted courteous and arbitrageurs' opportunities to invest in higher yields.

The role of banks turned them into "Premium-Makers" by discounting their premiums from the return that should have been granted to the investors themselves if they had the chance to directly invest their capitals in the government debt. The active engine of the banks was the easily generated profits beside the fact that contributed in abusing the advantage of the possibility of converting the generated profits generated in the local currency to USD as a pegged foreign currency. Thus, the ultimate fact would be the incremental level of the money supply in the Lebanese deteriorated economy that have already exceeded its domestic public and private debt and more than five time of its GDP.

2. Lebanese banks' income breakdown

Reviewing the annual reports of the banks that have been operating in Lebanon during the past three decades, precisely the part of the breakdown of liabilities, would lead to remark the elevated level of a continuously growing concentration in customer deposits as a main constituent of liabilities on the balance sheets of these banks. In fact, this indicator would advocate the investment anatomy of the Lebanese investors' perception. This fact illustrates the endeavors towards maintaining investments in the form of saving accounts with the bank that reimburse optimally the safest and highest yields on invested capital.

More relatively, the direct investment behavioral approach in the Lebanese financial market through the Lebanese local banks and financial institutions has been discouraged and yet it was alternated by encouraging the indirect investment approach in form of time deposit schemes. The deposits with the banks were rechanneled by the local banks for nurturing the domestic sovereign public debt. The latter process ultimately served the interests and objectives of the investors in the local banking sector regardless of the parties that were sponsoring the ultimate processes.

On the other hand, after reviewing the consolidated balance sheet of the same banks for the same financial periods, the attention will be all drawn towards the left side that has been floated with different financial papers invested in the Lebanese public debt that have already crossed the borders of eighty USD billions after 2017. In fact, the Lebanese public debt was designating the main gear of a well-structured engine that courteously generated the risk free and safe income for most of the banks operating in Lebanon for over than three decades.

The fundamental illustration in the form of technical presentation in the following reported figures and diagrams are extracted from the annual reports and disclosed financial statements of the top leading Alpha Banks (Top Lebanese Banks with more than $2B in deposits) operating in Lebanon for more than 10 years. The following illustration will highlight the level of concentration in liabilities of the banks chosen as the samples for undergoing various analyses in this paper.

Referring to the report issued by the Lebanese Ministry of Finance, Debt and Debt Markets, Issue No. 40, Q1, 2017, the actual allocation of the government debt liabilities as assets for other institutions being the holders of the debt in subject. The debt is presented as being held by 3 main holders being:

- The local banks with 65.90%
- The local public institutions with 21.50%
- Banque Du Liban (BDL) with 11.20%

The represented fact reflects that:

- The Local banks (Banks and Central Bank "BDL") are the main lenders for the Lebanese Government with an overall aggregate amount of 77.10%.
- Less than 22% of the Lebanese debt is held by local public institutions.
- by the banking industry with a high concentration that exceed three quarters of the debt value.
- The banking industry alone is highly exposed to the Lebanese Sovereign debt
- Other sectors and private institutional investors aren't holding or represented in holding the Lebanese sovereign debt.
- The sovereign debt is attractive and accessible and favorable to the Lebanese local banks.

"Shleifer claims that psychological evidence shows that people deviate from rationality mostly in the same direction. "This problem becomes more severe when the noise traders behave socially and follow each other's mistakes by listening to rumors or imitating their neighbors" (Shleifer, 2000, p.12). This behavior affects not only 'common people', but also to professional investors, traders and dealers, pension, and mutual fund managers, etc. Furthermore, not only professional managers are subject to the same behavioral biases as individual investors, but since they manage other people's money, their decisions could be severely affected by herd instinct. In capital markets and the asset management industry it is a frequent behavior to choose portfolios that resemble the benchmark the manager is evaluated against, or to make recommendations on stocks according to what other analysts or market consensus believe, to avoid a bad relative performance" (Peón and Calvo, 2012).

Consequently, the study flow will investigate the breakdown analysis of the Lebanese Local banks source of funds. The funds in the custody of the Lebanese banks are registered as assets after being invested in different nominal asset classes for generating income for the banks. However, once the funds are attracted to the banks, they are registered as liabilities on the balance sheets of the banks leading them to bear all the relative Cost of funds and the associated Risks of reinvestment, Liquidity, Market, and Credit.

There are 62 banks operating in Lebanon with an aggregate total deposit outstanding of USD 172 Bn. "Customer deposits have increased by around 8% to reach a new high of USD 172 billion at end-2016, with additional funds of around USD 10 billion entering the banking sector. Lending activity recorded a 5.4% growth during 2016, with total credit to the private sector exceeding USD 58 billion in December 2016" (Banque Du Liban, 2017).

The study will adopt a sample of 4 banks belonging to the Alpha group of banks operating in Lebanon being the highly ranked with more than $2B of customers' deposits. As it will be illustrated in the corresponding analysis that follows, the referenced sampled population dominating aggregate deposits, under the externally audited records of liabilities extracted from the relative officially disclosed annual financial statements, of USD 88Bn designating more than 51% of the total deposits of the whole industry that regulates 62 banks.

Table no. 1. Banks Customers' Deposits to Total Liabilities

Bank	Indicator	2014	2015	Average
Bank Audi	Customers' Deposits (Million)	USD 35,821	USD 35,609	USD 35,715
	Deposits to Total Liabilities	85%	84%	84.5%
Blom Bank	Customers' Deposits (Million)	USD 24,006	USD 25,091	USD 24,549
	Deposits to Total Liabilities	86.1%	85.8%	86.95%
Byblos Bank	Customers' Deposits (Million)	USD 15,715	USD 16,637	USD 16,176
	Deposits to Total Liabilities	82.6%	83.7%	83.15%
Bankmed	Customers' Deposits (Million)	USD 11,443	USD 11,656	USD 11,550
	Deposits to Total Liabilities	84.2%	86.1%	85.15%

Sources: Bank Audi Annual Report and 2015, BLOM Bank Annual Report 2015, Byblos Bank Annual Report 2015, Bankmed Annual Report 2015

Table no. 2. Weighted Average Customers' Deposits to Weighted Average Total Liabilities of the Sample

Bank	Yearly Average	Weight/Total	Yearly Average Dep./Lia.	Weighted Average
Bank Audi	$ 35,715	41%	84.50%	34%
Blom Bank	$ 24,549	28%	86.95%	24%
Byblos Bank	$ 16,176	18%	83.15%	15%
Bankmed	$ 11,550	13%	85.15%	11%
Total	$ 87,990	100%		85.02%

Sources: Bank Audi Annual Report and 2015, BLOM Bank Annual Report 2015, Byblos Bank Annual Report 2015, Bankmed Annual Report 2015

- ***Bank Audi:***

Referring Bank Audi Annual Report of 2015, the concluded figures indicate a high concentration of deposits in the nature of the bearing liabilities. For instance, Audi Bank liabilities breakdown reflects that:

- Total liabilities in the form of deposits: 89%.
  - 84% customer's deposits
  - 5% bank's deposits (Local Institutional Placements)

- ***Blom Bank:***

Referring Blom Bank Annual Report of 2015, the concluded figures indicate a high concentration of deposits in the nature of the bearing liabilities. For instance, Blom Bank liabilities breakdown reflects that:

- Total liabilities in the form of deposits: 88.2%.
- 85.8% customer's deposits
- 2.4% bank's deposits (Local Institutional Placements)

- ***Byblos Bank:***

Referring Byblos Bank Annual Report of 2015, the concluded figures indicate a high concentration of deposits in the nature of the bearing liabilities. For instance, Byblos Bank liabilities breakdown reflects that:

- Total liabilities in the form of deposits: 86.6%.
- 83.7% customer's deposits

– 2.9% bank's deposits (Local institutional placement)

- ***BankMed:***

Referring BankMed Annual Report of 2015, the concluded figures indicate a high concentration of deposits in the nature of the bearing liabilities. For instance, BankMed liabilities breakdown reflects that:

- Total liabilities in the form of deposits: 89%.

– 86.1% customer's deposits

– 2.9% bank's deposits (Local institutional placement)

As shown in the above referenced figures, the investments in the top Lebanese banks are highly exposed to a concentration in customers' deposits constituting the dominant source of funding as Liabilities.

Conclusions

Looking over the public debt figures, that exceeded USD 77 Billions, will also lead to conclude the level of contribution of the banks in supplying the correspondent funding of the public debt, exceeds 77%. In fact, this circle can simplify and demonstrate the role of the Lebanese banks as intermediaries between the government and the end investors for creating investments in the form of a spiral loop targeting the employment of the money supply within the local market.

The investors in the Lebanese banking sector enjoy courteous investment opportunities leveraging the burden of the Lebanese Public debt that is increasing with every sunrise to reach historical records against GDP. In fact, the local debt to income will involve increasing the interest rates that designate the premiums of debt growth that would be reflected by exposing the country to excessive levels of risks and costs burdens.

As a result, the banks in Lebanon are in front a surging need to start thinking of recrafting new business models by inventing modern financial investment strategies that suits their clientele and the industry simultaneously. However, the banks cannot be managing the whole process without having the support of the Lebanese legislative and regulatory bodies since many of the prevailing laws and regulations do not authorize many of the operations that corresponds to digital transactions and contracts.

The fact would lead the government, policymakers, regulator, economic sectors and banks to assume new financial models associated with the nature and with the roles of investment banks that would engage the processes of taking various business entities to the capital markets to raise their needed financing objectives. Furthermore, the latter process would lead to acquire new investment opportunities through the domestic capital and debt markets. Consequently, the banks shall be able to assume new Initial Public Offerings, innovative well-crafted financial products and services on their shelves so that to introduced to the major stakeholders in the Lebanese financial industry.

Finally, the adoption of the referenced recommended approach in developing the Lebanese financial industry by renovating the role of Beirut Stock Exchange in supporting all the economic sectors in raising their finances and by deliberating the structure of revolutionary domestic capital markets and debt markets would be incentivizing, rebating and reimbursing all the performance of the whole Lebanese economy with direct and indirect renders.

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