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## 1) Introduction:

Like all small economies, Lebanon relies extensively on its external sector. Whereas this outward orientation of the country has its blessings, it makes the country ever more vulnerable to external setbacks and shocks. This seems to have come to a head at about 2012, when the Syrian war took a really bad turn, and when political tensions intensified in the country. It was also the time when fiscal policy started to be more expansionary and reckless in the context of the fixed exchange rate regime. To a large extent, the ensuing period till 2019 set the stage for the severe crisis that the country is going through now.

The aim of this short note is to shed light on Lebanon's external sector during those crucial periods, so as to better understand this vital sector and be able to devise future policy proposals that reignite its vitality with minimal volatility. In section two we describe the size and patterns of Lebanon's goods trade in recent years; in section three we analyze more broadly the country's trade in goods and services and the current account for the 2006-2018 period, in addition to calculating some tentative but indicative trade elasticities; in section four we do the same but for an analysis of capital flows; and in section five we conclude.

## 2) Goods Trade:

What is striking about trade in goods for Lebanon is the extent of goods imports. In 2019, goods imports stood at \$19.24 billion, equivalent to 35.6% of GDP, and less by 3.7% than goods imports in 2018, as can be seen from Table (1). What is interesting is that all goods imports decreased in 2019, except for mineral products which increased from \$4.2 billion to \$6.6 billion! Mineral products constituted 34.3% of goods imports, followed by chemical products at 10.34%, machinery at 8.63%, and transport equipment at 6.13%. The top six import sources in 2019 were: USA (8.9%), China (8.5%), Greece (7.3%), Russia (7%), Italy (6.9%), and Germany (5%); only Russia's share was notably higher rising from a tiny 2.8% in 2018.

**Table (1): Goods Trade (Millions of USD)**

		Imports		Exports		
Goods		2018	2019	2018	2019	
01	Live animals; animal products	1,039	841	24	23	
02	Vegetable products	965	932	183	175	
03	Animal or vegetable fats and oils	156	125	55	58	
04	Prepared foodstuffs; beverages, tobacco	1,335	1,214	383	371	
05	Mineral products	4,169	6,609	31	58	
06	Products of the chemical or allied industries	2,213	1,991	362	369	
07	Plastics and articles thereof; rubber	773	643	180	153	
08	Raw hides and skins, leather, fur skins	67	56	11	13	
09	Wood & articles of wood	225	175	8	13	
10	Pulp of wood; paper and paperboard	345	279	140	144	
11	Textiles and textile articles	757	607	52	49	
12	Footwear, umbrellas, artificial flowers	140	115	9	10	
13	Articles of stone, plaster, cement, glass	445	307	24	19	
14	Pearls, precious stones and metals	1,252	931	648	1,455	
15	Base metals and articles of base metal	1,269	850	380	297	
16	Machinery & mechanical Appliances	2,321	1,665	322	382	
17	Transport equipment	1,659	1,175	23	28	
18	Optical instruments & apparatus	366	337	17	15	
19	Arms and ammunition; parts and accessories	17	11	0	2	
20	Miscellaneous manufactured articles	439	355	86	89	
21	Works of art, collectors' pieces and antiques	26	20	16	8	
<b>Total</b>		<b>19,980</b>	<b>19,239</b>	<b>2,952</b>	<b>3,731</b>	
<b>Major Trading Partners (Million USD)</b>						
		Imports		Exports		
		2018	2019	2018	2019	
	<b>United States</b>	1,438	1,705	<b>Switzerland</b>	131	1,062
	<b>China</b>	2,048	1,627	<b>UAE</b>	457	439
	<b>Greece</b>	1,708	1,401	<b>Saudi Arabia</b>	212	246
	<b>Russian Federation</b>	567	1,344	<b>Syria</b>	205	190
	<b>Italy</b>	1,591	1,326	<b>Iraq</b>	147	146
	<b>Germany</b>	1,169	954	<b>Qatar</b>	133	128
	<b>Turkey</b>	949	940	<b>Jordan</b>	86	89
	<b>France</b>	709	769	<b>Egypt</b>	71	78
	<b>United Arab Emirates</b>	588	564	<b>US</b>	63	69
	<b>Kuwait</b>	270	557	<b>South Africa</b>	174	69
	<b>Other Countries</b>	8,943	8,053	<b>Others</b>	1,273	1,215
<b>Total</b>		<b>19,980</b>	<b>19,239</b>	<b>Total</b>	<b>2,952</b>	<b>3,731</b>

Source : Lebanese Customs

As for exports, the story is less compelling. Goods exports stood at \$3.73 billion in 2019, only 6.9% of GDP, but higher by 26.4% on goods exports in 2018. All of goods exports stayed largely the same except for pearls and precious stones which increased from \$648 million to \$1.46 billion and machinery which increased from \$322 million to \$382 million. Additionally, pearls and precious stones took 39% of goods exports, followed by machinery at 10.2%, prepared foodstuffs at 9.9%, and chemical products at 9.8%. The main exports destinations in 2019 were: Switzerland (28.5%), UAE (11.8%), KSA (6.6%), Syria (5.1%), Iraq (3.9%), and Qatar (3.4%) – with the share of Switzerland rising markedly from 4.4% in 2018 -- thus showing the significance of Arab markets to Lebanese exports.

As a result, the trade deficit in goods in 2019 stood at \$15.87 billion or 29.4% of GDP, lower by 6.81% from 2018. And the outcome was due to the exceptional performance in the exports of mainly pearls and precious stones. But exports of goods remain overall considerably less than their historical average, which stood at 18% of GDP between 1970 and 2018.

### 3) Trade and Current Accounts:

The discussion above was incomplete because it focused on trade in goods only. What we are going to explore in this section is an analysis of the trade account in goods and services and the current account. Luckily, the Central Administration of Statistics (CAS) has published recently the full GDP expenditure accounts for the period between 2006 and 2018, which we will utilize in Table (2). As can be seen from the Table, export of goods and services (X) averaged \$11.56 billion during the period, but slowed down since 2011 because of the decline in goods exports (XG) as a result of the Syrian war. However, imports of goods and services (M) rose notably throughout the period, driven as is well known by an expansionary fiscal policy, and averaging \$22.81 billion<sup>1</sup>. The resulting trade deficit in goods and services averaged \$11.25 billion, but has remained as usual less than the trade deficit in goods by about \$2.5-3 billion.

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<sup>1</sup> Especially since 2017 with the increase in public wages by more than 50% which drove the deficit to GDP ratio close to 11%.

**Table (2) : Trade in Goods and Services (Billions of USD)**

	GDP	X	XG	XS	M	REER	Δ GDP	Δ X	Δ XG	Δ XS	Δ M	ΔREER
2006	22.01	7.84	2.71	5.13	12.22	103.46						
2007	24.83	9.22	3.56	5.67	15.10	100.00	2.82	1.38	0.85	0.54	2.88	-3.46
2008	29.12	11.22	4.44	6.78	19.82	99.61	4.29	2.00	0.88	1.11	4.72	-0.39
2009	35.40	11.75	4.13	7.61	20.25	102.17	6.28	0.53	-0.31	0.83	0.43	2.56
2010	38.44	13.46	4.69	8.77	23.09	102.21	3.04	1.71	0.56	1.16	2.85	0.03
2011	39.93	14.52	5.43	9.09	26.26	99.15	1.48	1.05	0.74	0.32	3.17	-3.06
2012	44.04	12.68	5.38	7.31	26.29	102.53	4.11	-1.84	-0.05	-1.79	0.03	3.39
2013	46.91	12.49	4.95	7.54	27.91	103.37	2.87	-0.19	-0.43	0.23	1.61	0.84
2014	48.13	11.43	4.36	7.07	26.96	105.71	1.23	-1.07	-0.59	-0.46	-0.94	2.34
2015	49.94	11.55	3.82	7.74	24.32	111.12	1.80	0.13	-0.54	0.66	-2.65	5.41
2016	51.21	11.11	3.76	7.35	23.53	108.89	1.27	-0.44	-0.05	-0.39	-0.79	-2.23
2017	53.14	11.63	3.86	7.77	24.67	107.71	1.94	0.51	0.09	0.42	1.15	-1.18
2018	54.96	11.39	3.67	7.72	26.07	106.17	1.82	-0.24	-0.19	-0.05	1.40	-1.55
<b>Average</b>	<b>41.39</b>	<b>11.56</b>	<b>4.21</b>	<b>7.35</b>	<b>22.81</b>	<b>104.01</b>	<b>2.75</b>	<b>0.30</b>	<b>0.08</b>	<b>0.22</b>	<b>1.15</b>	<b>0.23</b>
<i>Source: CAS, BdL, Brugel</i>												

The interesting thing about the time series data in Table (2) is that it allows us to calculate the impact of changes in income (or GDP) and exchange rates on exports and imports of goods and services. To motivate this analysis, we are going to employ the standard concept of the elasticity, which measures the effect of a 1% change in the variable x on the percentage change of the variable y<sup>2</sup>. For instance, the elasticity of M with respect to GDP is the percentage change in M divided by the percentage change in GDP, and it can be represented as:  $(\Delta M/\Delta GDP).(GDP/M)$ . More specifically, from Table (2), this elasticity is  $(1.15/2.75).(41.39/22.81)$ , and is equal to 0.76. Similarly, we can calculate the elasticity of M with respect to the exchange rate, but the exchange rate here is presented as the real effective exchange rate (REER), which expresses the exchange rate vis a vis Lebanon's major trading partners taking into account differences in inflation rates<sup>3</sup>. Note that a higher REER indicates an appreciation of Lebanon's real exchange rate (a higher price of Lebanese goods and services to foreigners or alternatively a cheaper price of foreign goods and services to the Lebanese). In Table (3) below, we list the various elasticities relevant to Lebanon's external sector.

<sup>2</sup> The elasticity is equal to:  $(\Delta y/y).100/(\Delta x/x).100 = (\Delta y/\Delta x).(x/y)$ .

<sup>3</sup> This is because demand for exports and imports is determined by exchange rates as well as prices.

**Table (3): External sector Elasticity Values**

Elasticity	Value
Elasticity of M with respect to GDP	0.76
Elasticity of M with respect to REER	0.23
Elasticity of X with respect to REER	0.12
Elasticity of XG with respect to REER	0.09
Elasticity of XS with respect to REER	0.13
Elasticity of Deposit with respect to $i$	1.67
Elasticity of Portfolio with respect to $r$	-6.54

Although the previous analysis was perhaps tediously technical, however its implications are easy and important. Increases in income or GDP produce positive changes in M, such that a 1% increase in GDP increases M by 0.76%. Similarly, a 1% appreciation in the real exchange rate increases imports by 0.23%<sup>4</sup>. The surprising result is that the elasticity of X with respect to REER is not negative but positive at 0.12 (also positive for XG at 0.09 and for XS at 0.13), which means that an appreciation of REER increases exports instead of reducing them, though the effect is small. This surprising result is perhaps due to the fact that most of Lebanon’s goods exports (like pearls and precious stones) are not very price sensitive and so is service exports (like tourism)<sup>5</sup>.

Moreover, two important implications emerge from the above. First, the REER appreciation that Lebanon experienced over the period had a larger impact on imports (0.23 vs 0.12) than exports, thus contributing to further trade deficits over the period. Second, the elasticity of M with respect to GDP is larger than that with respect to REER (0.76 vs 0.23) as is usually the case for most countries, which implies that the severe reductions in GDP that the economy will experience in 2020 (and beyond) will have a pronounced effect on M and consequently on the trade deficit.

Lastly, what about the current account? Accounting-wise the current account is made up of the balances on goods and services, income, and current transfers. In Lebanon, the main two components are trade in goods and services and current transfers as remittances. Table (4) shows that the current account has been in deficit throughout the period but has really got out of hand starting in 2012, averaging close to \$8.1 billion for the period. As to remittances *inflows*, they peaked in 2015 but slowed down later to average \$2.53 billion<sup>6</sup>. So we can see that the current account deficit is roughly equal to the trade deficit in goods and services minus remittances. And this implies – and worth re-emphasizing -- that correcting for current account deficits is largely a story about reducing trade deficits.

<sup>4</sup> Note that in case of the elasticities with respect to REER, they are calculated such that the index for REER is deflated by 100.

<sup>5</sup> These elasticities agree largely in size and sign with more rigorous estimates arrived at by Azar, et al. (2019). “Empirical Analysis of Merchandise Trade and the Current Account: Lebanon”, *Lebanese Science Journal*, Vol. 20, No. 1.

<sup>6</sup> Remittances are less than those reported by the World Bank at \$7-8 billion because the latter usually includes FDI and deposit investments (recorded in the capital and financial accounts) in addition to current transfers.

**Table (4) : Current and Capital and Financial Accounts (Billions of USD)**

	TD	Remit	CA	FDI	Portfolio	Deposit	BoP	R(%)	I(%)	$\Delta$ Port	$\Delta$ Dep	$\Delta r$	$\Delta i$
2006	-4.38	1.84	-1.12	3.13	2.02	0.52	2.97	7.8	4.75				
2007	-5.88	2.66	-1.6	3.38	1.73	1.72	2.04	8.25	4.69	-0.29	1.2	0.45	0.45
2008	-8.60	2.2	-4.15	4.33	1.2	2.33	3.46	8.91	3.33	-0.53	0.61	0.66	0.66
2009	-8.50	1.67	-7.02	4.8	4.03	5.35	7.9	5.31	3.05	2.83	3.02	-3.6	-0.28
2010	-9.63	2.67	-7.58	4.28	-0.74	1.82	3.3	4.14	2.8	-4.77	-3.53	-1.17	-0.25
2011	-11.74	2.47	-4.78	3.49	-1.18	3.94	-2	4.44	2.83	-0.45	2.12	0.3	0.03
2012	-13.61	2.1	-10.32	3.11	0.6	2.57	-1.6	4.44	2.86	1.78	-1.37	0	0.03
2013	-15.41	2.32	-11.96	2.66	0.93	3.52	-1.2	5.1	2.95	0.33	0.95	0.66	0.09
2014	-15.54	2.81	-12.61	2.86	2.82	2.73	-1.4	4.52	3.07	1.89	-0.79	-0.58	0.12
2015	-12.76	3.58	-8.54	2.16	-0.72	2.39	-3.4	5.55	3.17	-3.54	-0.34	1.03	0.1
2016	-12.41	3.4	-10.47	2.57	6.14	1.73	1.2	6.31	3.52	6.86	-0.66	0.76	0.35
2017	-13.05	2.74	-12.13	2.52	4.76	2.68	-0.16	6.74	3.89	-1.38	0.95	0.43	0.37
2018	-14.68	2.43	-12.44	2.63	-1.91	4.27	-4.8	10.32	5.15	-6.67	1.59	3.58	1.26
<b>Avr</b>	<b>-11.25</b>	<b>2.53</b>	<b>-8.06</b>	<b>3.22</b>	<b>1.51</b>	<b>2.74</b>	<b>0.49</b>	<b>6.29</b>	<b>3.54</b>	<b>-0.33</b>	<b>0.31</b>	<b>0.21</b>	<b>0.24</b>

Source : BDL and ABL

#### 4) Capital Inflows and BOP:

The capital and financial accounts in the balance of payments (BOP) are made up primarily of capital transfers, FDI, and portfolio and deposit investments. Table (4) records these inflows except for capital transfers. FDI seemed to have peaked at \$4.3 billion in 2010 but slowed later on to average \$3.22 billion for the period; however, portfolio investments proved to be the most volatile, oscillating between negative and positive flows and averaging \$1.51 billion; whereas deposits reached a plateau at close to \$4 billion in 2011, slowed down later, but increased back again in 2017 and 2018 -- stimulated by the higher interest rates during those two periods due to BDL's financial engineering -- to average at \$2.74 billion. More important, these inflows, especially since 2011, were not enough to cover for the current account deficits such that the BOP ended up in the red for the remainder of the period (except 2016) and erasing all the gains in BOP made earlier.

Interestingly, we can construct relevant elasticities for these capital inflows, specifically portfolio and deposit investments. These elasticities will be with respect to the average interest  $i$  for USD deposits and with respect to the average yield on Lebanese Eurobonds  $r$  for portfolio investments. As we can see from Table (4), the behavior of  $i$  and  $r$  mirrored each other pretty well, in the sense that they first fell to a minimum at about 2012 and then rose again for the rest period, averaging 6.29% for  $r$  and 3.54% for  $i$ . And the corresponding elasticities can be calculated as -6.53 for portfolio investments and 1.67 for USD deposits, as is recorded in Table (3). This shows that, for instance, a 1% increase in the average yield on Eurobonds will reduce portfolio investments by 6.57% because of the higher risk involved. Whereas a 1% decline in average interest on USD deposits will reduce these

deposits by 1.67% only. Clearly, portfolio investments are more elastic to interest rate changes than deposits since the latter are done mostly by Lebanese expatriates who have a domestic bias towards investments in their country, whereas portfolio investments are undertaken by foreign institutional investors.

### 5) Conclusion:

This short note highlights the dynamics and sustainability of Lebanon's status as a trading and investment country where its vulnerability has surfaced in light of the geopolitical uncertainties surrounding it. A turning point was reached with the October 2019 uprising that dragged the country into an unprecedented economic and financial descent. Broadly speaking, the underlying dominating factor has been the loss of confidence in the system of policymaking whereby decades of political bickering led to a swaying away from achieving the genuine interest of the public good. Thus, to alleviate the current situation, a number of policy measures ought to be put in place and implemented to save the day. It should start and not be limited to harmonizing international relations to restore the trust with nations that have the highest input into Lebanon's wellbeing.

A starting point would be to strengthen relations with our Arab neighbors where almost half of Lebanese exports end up and an equal amount of remittances originate. Another policy proposal has to do with the wider diversification of the industrial and manufacturing base. Needless to say, the re-engineering of Lebanon's industrial infrastructure has to be accompanied by a more realistic and flexible exchange rate system that will enhance competitiveness of import substituting industries. As important, concurrent trade imbalances have fueled current account deficits that together with budget deficits have given rise to the twin deficits. In order to tackle this phenomenon, fiscal policy needs to be rationalized and readjusted to streamline government spending towards productive sectors of the economy. In parallel, a more conducive political environment will not only re-attract much-needed capital investments but also reduce the cost of government borrowing alongside the development of capital markets. And as it has been repeatedly proven – even in previously challenging security and economic times -- Lebanon's vast expat community represents a loyal base of investors into their homeland. But this time it comes with a caveat of maintaining trust in the overall economic and banking framework of the country. Last but not least, and lest common sense be the least common in Lebanon, a reform and confidence-building program with the international donor and financial institutions is the most sensible option to approach this whole process, sooner rather than later.

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