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It is generally known that the Lebanese economy extends to all five continents of the globe given that – by some estimates – more than 10 million Lebanese live outside the country. That is of course not counting what non-resident foreigners can contribute to the economy. All that has made the economy's external sector the most vital part of the economy, perhaps to the detriment of the domestic economy and what it can contribute to the economic life of the country. This issue is taking a new importance now, as the country is embarking on a new economic course to get out of the severe crisis it is stuck in and to meet the frustrated economic hopes of its people. And it is especially interesting given the vulnerability of the economy to the availability of external sources, as in the current situation where these sources have gone into "sudden stop".

What we would like to do in this spotlight is to shed some light on this matter. More specifically, we want to calculate the contribution of domestic and external sources to economic growth, and then draw some implications concerning the size of each contribution, in addition to tentative conclusions on how to stimulate the deficient domestic sources so as to enhance and deepen the productivity of the economy. To do that we have to work from basics, and that most often means the GDP identity. The latter simply implies¹:

$$(1) \quad I = Sd - TB$$

Where I is private and public investment, Sd is domestic savings, and TB is the trade balance *in goods and services*. Since Lebanon has a perennial trade deficit TD (a negative TB), then (1) can be written as:

$$(1) \quad I = Sd + TD$$

Equation (2) is extremely important; it shows that resource flows from outside – net debt, equity, FDI, or draw-down of foreign reserves – cover for the excess of investment over domestic savings Sd

¹ Since $GDP = C + I + TB$, where C is private and public consumption, I is private and public investment, and TB is the trade balance or net exports, then $GDP - C$ is equal to domestic savings Sd . Rearranging terms we get: $I = Sd - TB$. In case of the gross national product GNP , the relation becomes: $I = Sn - CA$, where Sn is national savings and CA is the current account balance.

and thereby close the resource gap. In other words, investment is financed by domestic savings and resource flows identical in magnitude to the trade deficit in goods and services.

We can do simple adjustments to equation (2) to arrive at an expression that determines the contribution of domestic savings and external resource flows to GDP growth. Multiplying both sides of (2) by $\Delta Y/Y$ – where Y is nominal GDP -- and rearranging the resulting terms we get:

$$(2) \quad \Delta Y/Y = (Sd/Y + TD/Y) \Delta Y/I$$

Since $\Delta Y/Y$ is the rate of growth of nominal GDP, then from (3) we can see that $\Delta Y/Y$ is obtained as the sum of domestic savings and resource flows from outside, each as a ratio of Y and each weighted by $\Delta Y/I$. Hence, the growth in nominal income is the sum of growth emanating from domestic and external sources. As important, note that $\Delta Y/I$ is simply $\Delta Y/\Delta K$ since investment I is the change in the capital stock K , which makes $\Delta Y/I$ as the marginal productivity of capital.

Fortunately, we have recent data to operationalize equation (3). The Central Administration of Statistics (CAS) has just published its new *National Accounts for Lebanon* from 2006 to 2018. Tables (1) and (2) record the behavior of all the variables incorporating equation (3), and they reveal the following important observations:

First, the investment ratio I/Y averaged 24.4% and has witnessed a notable downtrend since 2013; whereas the ratio of the trade deficit to GDP TD/Y averaged close to 27% and has remained largely steady.

Second, the ratio of domestic savings to GDP Sd/Y averaged -2.5% and has actually become more negative since 2012. A negative Sd/Y means of course that public and private consumption is larger than GDP (see footnote 1).

Third, the productivity of capital as measured by $\Delta Y/I$ averaged 0.28 and has fallen considerably since 2012 to settle at 0.16 in 2018..

Fourth, the rate of real GDP growth g fell noticeably since 2012, and has turned to negative 1.9% in 2018; while the inflation rate as measured by the GDP Deflator had been relatively high only during the boom years of 2008-2012 and averaged 3.74%. Accordingly, the actual rate of nominal GDP growth $yact$ (which is the sum of y and Deflator) has followed mostly the same pattern as g and averaged 7.47%.

Fifth, and most important, the calculated nominal growth of GDP y_{cal} as derived from equation (3) has shown a great resemblance to the actual one $yact$: y_{cal} averaged 7.21% against a $yact$ of 7.47%. And it also shows that the contribution to growth from domestic sources Sd has been negative at an average of 0.5%, whereas the contribution from external sources has averaged a positive 7.7%.

These are remarkable yet somehow expected results for people familiar with the Lebanese economy. But they should point to very essential implications and sound policy proposals and reforms:

First, the decline in investment and the productivity of capital since 2012-2013 reflects a marked deterioration in the investment climate. In this respect, reforms should not only focus on improving the ease of doing business, but they should also involve better governance of public institutions and, as crucially, a stable political environment.

Second, the dissaving in the domestic economy (or the negative S_d) has been largely driven by dissaving in the public sector. The tragedy of budget deficits in the country (at more than 10% of GDP lately) is that they are the outcome of excessive current expenditures (40% on wages and pensions², 35% on interest payments, and 15% on EDL), and the resulting high consumption in the economy – no doubt a considerable part of it is unproductive – has been actually *robbing from growth instead of contributing positively to it*. The obvious but profound policy implication here is that budget deficits have to drop, wasteful and corrupt expenditures have to be eliminated, and a more sustainable fiscal plan has to be implemented. That is not to say that only public dissaving has to be blamed and private savings is off the hook – not at all. As we have shown elsewhere³, both Lebanese households and businesses save relatively little (close to 7% of GDP) and policies should be designed to reverse that in the medium-to-long term.

Third, and most crucially, it is clear that external resources have been doing all the work and more when it comes to contributions to growth in the Lebanese economy. What is particularly interesting is that while capital flows slowed down noticeably since 2012, what kept TD steady is the draw-down of foreign reserves at BDL – another external resource -- which had to pay for the steady balance of payments deficits of more than \$18 billion since 2012. And it is here that the misfortune of relying on external sources for growth also manifests itself, in that when capital flows slow down it is foreign reserves that have to bleed and pick “up the tap”. What makes this result even more distressing is that it is like these foreign reserves have been almost squandered because of their limited growth mileage given the low marginal productivity of capital of the later years.

We would like to conclude by stressing the policy implications emanating from the third point above. It is clear that the growth of the Lebanese economy has been extremely vulnerable to external resources. This of course came to a stark head in October 2019 onward when external flows dried up and came to a “sudden stop”⁴. The delinking from international and regional capital markets has put foreign reserves again as the sole source for external resources, the result of which is that BDL is now rationing the use of its exhaustible foreign reserves (at close to \$37 billion currently)⁵. This is no doubt an unsustainable position, which means that the utmost priority of the new government is to secure concessional official funding – through “Cedre”, Arab regional Funds, or even the IMF – to stop the hemorrhage in BDL foreign reserves and bring in needed external flows to restore economic growth. But this is only the short-term measure, for in the medium-to-

2 It is widely believed that one important trigger of the crisis was the increase in public wages by more than 50% starting in October 2017.

3 See “Savings, Investment, and the Current Account in the Lebanese Economy”, Lebanon Brief, January 11, 2020. BlomInvest Bank..

4 The reasons behind the “sudden stop” are largely due to the temporary capital controls imposed by the banking system and the possibility of a default on Lebanese Eurobonds.

5 And because of the limited nature of these reserves, that should generate negative growth rates ala equation (3), as some estimates indicate for 2020.

Contributions to Growth in the Lebanese Economy: The Need to Invigorate Domestic Sources

long term the government has to implement reform measures that invigorate the domestic resources of the economy, increasing savings (both public and private), promoting exports, and substituting for imports, and thus obviating or lessening the need for external funding sources. And this is especially required at a time when international and regional capital markets are becoming increasingly competitive and unforgiving. Of course, what should underlie this long-term process is a steady improvement in the productivity and governance of the economy. In the end, what marks a solid economy is not only its ability to overcome a crisis but also to eliminate the vulnerability to crises. That is the real achievement.

Contributions to Growth in the Lebanese Economy: The Need to Invigorate Domestic Sources

Table (1)

	I/Y	TD/Y	Sd/Y	Y	ΔY	I	ΔY/I
2006	21	20	1	33199			
2007	24	24	0	37427	4228	9088	0.47
2008	28	30	-2	43897	6470	12289	0.53
2009	27	24	3	53365	9468	14366	0.66
2010	25	25	0	57954	4589	14452	0.32
2011	27	29	-2	60190	2236	16159	0.14
2012	25	31	-6	66384	6194	16448	0.38
2013	28	33	-5	70716	4332	19514	0.22
2014	25	32	-7	72563	1847	18102	0.10
2015	22	26	-4	75284	2721	16727	0.16
2016	23	24	-1	77192	1908	17522	0.11
2017	21	25	-4	80110	2918	17123	0.17
2018	21	27	-6	82854	2744	17227	0.16
Average	24.4	26.9	-2.5	62395.0	4137.9	15751.4	0.28

Table (2)

	g	Defaltor	y act	cont TD/Y	cont Sd/Y	y cal
2006	1.5	0.9	2.4			
2007	9.3	3.1	12.40	11.17	0.00	11.17
2008	9.1	7.5	16.60	15.79	-1.05	14.74
2009	10.2	10.3	20.50	15.82	1.98	17.79
2010	8	0.6	8.60	7.94	0.00	7.94
2011	0.9	3	3.90	4.01	-0.28	3.74
2012	2.5	7.6	10.10	11.67	-2.26	9.41
2013	3.8	2.6	6.40	7.33	-1.11	6.22
2014	2.5	0.1	2.60	3.27	-0.71	2.55
2015	0.2	3.5	3.70	4.23	-0.65	3.58
2016	1.5	1	2.50	2.61	-0.11	2.50
2017	0.9	2.9	3.80	4.26	-0.68	3.58
2018	-1.9	5.5	3.60	4.30	-0.96	3.34
Average	3.73	3.74	7.47	7.70	-0.49	7.21

Source : CAS, *Lebanese National Accounts*

Note: All variables are in percentage terms except Y and I which are in billions of Lebanese pounds and ΔY/I which is a numerical ratio.

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