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The Lebanese economy was on fairly shaky grounds prior to 17 October 2019 but the economic crisis that has ensued since then was beyond anyone's expectations in its severity. Four factors have inflamed the crisis and have added to its spread: first, the Corona epidemic; second, a political uprising that had initially shown a lot of promise but that later created havoc and ultimately fizzled without any meaningful impact; third, the tragic explosion to the Port of Beirut on August, 4 2020; fourth, and most important, the absence of any government corrective measures, let alone a steady functioning government, to tackle the crisis because of the hopeless and endless bickering among political parties. The crisis, naturally, has spawned many economic issues and problems, and what we want to do in this note is to address four of them, namely: the extent of smuggling in petroleum products; the optimal magnitude of foreign reserves; the probable size of capital outflows; and the impact on aggregate expenditures and output. We have addressed the first two issues in Part 1 of the note; so we will analyze the remaining two issues in this Part 2 of the note.

Despite the de-facto capital controls, capital outflows have continued to seep out of the country at a time of severe foreign exchange shortages. The issue of capital outflows is of course a highly emotional one because it ties to the ubiquitous capital flight by corrupt politicians and business people. But it has attracted a more rational tone since the promulgation of Circular 154 by BDL that requires banks to repatriate at least 15% of their clients' money that has left the country since Q2 2017. And one influential and interesting article belonging to this rational tone is the article by the Secretary General of ABL, Dr Makram Sader, which appeared in the Annhar newspaper on 4 September 2020.

To arrive at a reasonable estimate of capital outflows we have to understand the mechanics of the balance of payments (BOP). The equation below does that:

$$(1) \qquad TB + IT + KA + \Delta R = 0 \quad \text{or} \quad TB + IT + KA = -\Delta R$$

In equation (1), TB is the trade balance, IT is income and transfers from abroad such that TB + IT is equal to the current account CA, KA is the capital and financial account, and ΔR is the change in foreign reserves. For the BOP to be in balance, the items in equation (1) should add to zero. This means, alternatively, that if TB + IT + KA are negative or in deficit, then the BOP is in deficit and for it to balance ΔR has to decline by the same amount as the BOP deficit.

If we restrict our computations to the first two quarters of 2020, then it is reasonable to assume that TB would be mostly represented by TB in goods and IT would be represented by remittances only[1]. In Q1 2020, TB was in deficit at $2 billion, IT would have been positive at about $2 billion (a quarter of annual remittances of $8 billion that one would expect to continue flowing into the country but not necessarily through the banking system), and the BOP was negative at $1.1 billion. This leaves KA at a negative $1.1 billion, implying net capital outflows of $1.1 billion, which incidentally is very close to the

[1] *Trade is services in Lebanon is dominated by tourism, which has been largely absent in 2020, and income transfer has also limited , especially after the default on public foreign debt in March 2020*

figure of $1.2 billion arrived at by Dr Sader (in the previously mentioned article) and calculated by a different methodology utilizing BIS's data on net cross-border positions of the Lebanese.

Stretching the data for H1 2020, and noting that for that period TB was negative $3.6 billion, IT was positive $4 billion, and the BOP was in deficit at $2.5 billion, then KA would have been negative $2.9 billion i.e. net capital outflows would have increased by $1.8 billion in Q2 2020. These are not small numbers, especially for half a year; and they signify the urgency to have a de-jure capital control law which would be strictly enforced. As important, such a law will not only close a porous capital and financial account, but will also satisfy one of the crucial pre-conditions for an IMF program.

The last issue that we want to tackle is the impact of the crisis on aggregate expenditures and output. It was repeatedly argued before the crisis – and rightly so – that the Lebanese live beyond their means since they incur large current account deficits (in excess of 20% of GDP) that have to be financed from abroad or through the depletion of foreign reserves. To what extent has the crisis done that and how? To answer this question, we have to have to investigate the following basic but fundamental expenditure and output relationship:

$$(2)\quad A = GDP + TD$$

In equation (2), A stands for absorption which is equal to consumption and investment by both the private and public sectors, GDP is gross domestic product, and TD is the trade deficit. Equation (2) simply says that the economy absorbs and spends what it produces domestically (GDP) and what it receives in goods and services in net terms from abroad (TD). Equation (2) can be expanded to:

$$(3)\quad \%\Delta \text{ in } A = S1 \times \%\Delta \text{ in } GDP + S2 \times \%\Delta \text{ in } TD$$

Where S1 is the share of GDP in A, and S2 is the share of TD in A[2]. If we concentrate on the period extending from H1 2019 to H1 2020, then we find the following: TD stood at $3.6 billion in H1 2020, less by 57.3% than H1 2019; and reliable estimates put GDP in USD terms at $49 billion in 2019 and at $26 billion in 2020, thus implying a reduction of 46.9% between H1 2019 and H1 2020[3] And given that historically GDP was 72% of A and TD was 28% of A, then (3) becomes:

$$(4)\quad \%\Delta \text{ in } A = (-46.9\%) \times 0.72 + (-57.3\%) \times 0.28$$

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Equation (4) implies a %Δ in A equal to -49.8%. This means that in USD terms the consumption and investment of both the private and public sectors fell by close to 50% from H1 2019 to H1 2020. This is a very drastic reduction in absorption and living standards that is more than warranted and that goes beyond the need to "tighten belts and to live within one's means", especially that it took place in one single year. And perhaps it is the lack of any reform and corrective measures by the government for more than a year that explains such a severe and hard adjustment in absorption, let alone its disastrous impact on employment especially among the youth.

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[2] *Since A = GDP + TD, then ΔA = ΔGDP + ΔTD, or ΔA/A = ΔGDP/A + ΔTD/A, or ΔA/A = (ΔGDP/GDP).(GDP/A) + (ΔTD/TD).(TD/A), which is equivalent to equation (3) in percentage terms.*

[3] *The comparison is between half-year GDPs. The figures are taken form the Diab Government Reform Plan, which incidentally agrees with figures from the ABL counter plan. The GDP figure for 2020 is estimated at the exchange rate of 3,500 LBP for I USD, which is a reasonable average given the multiplicity of prevailing exchange rates*

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