Exchange Rates in Lebanon during the Financial Crisis

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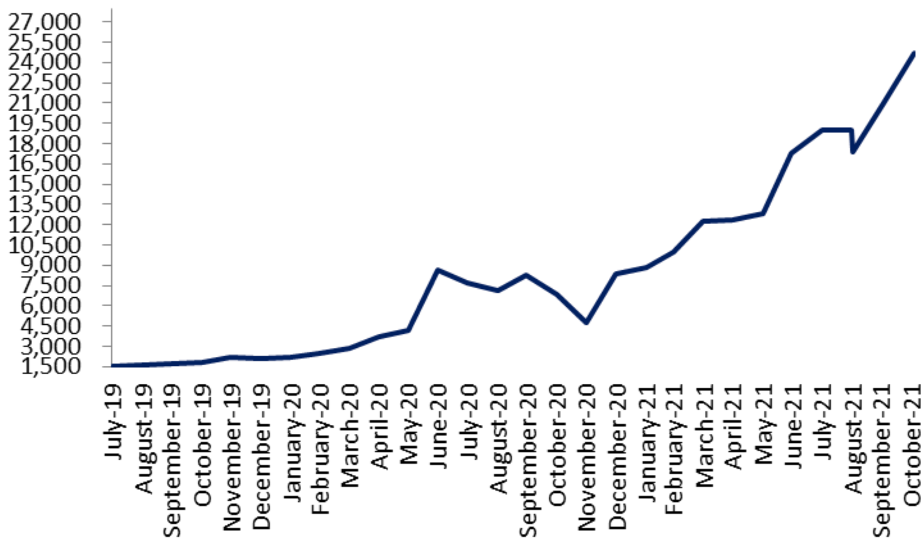
To a large extent, the financial crisis in Lebanon has revealed the "real" value of the Lebanese lira against the dollar. In retrospect, the 1,500 LBP/USD rate has proven to be an unrealistic peg as this rate – as anecdotal evidence would have it -- was sustained in 2017-2018 for instance by the financial engineering operations adopted by BDL. As a result, for all intents and purposes, the official rate has come now to an end.

As to the exchange rate in the parallel or black market, several fundamental factors are affecting it and contributing to its deterioration: prime among these, is the troubled political situation in the country and the uncertainty arising from the government deadlock; in addition, there is the worsening economic situation, driven by default, declining income and output, and internal and external imbalances. And to "add insult to injury", there is the mismanagement of the financial crisis and the absence of any corrective or reform measures to stop the hemorrhage in the national economy.

For a meaningful analysis, we will present below the major determinants of the exchange rate in the parallel market; more specifically, we will link the fluctuation of exchange rate in the parallel market to the major political and economic fundamentals that have occurred during the crisis period. As we know, the Lebanese lira in the parallel market is unstable as the volatility is high against the dollar during that period. Some blame the platform applications or social media and accuse the people behind them that they are manipulating the market for an arbitrage purpose. However, we can't deny that the political and economic situation was the main reason behind the huge depreciation of national currency. As such, we will show that by analyzing the evolution of the exchange rate against the dollar from September 2019 until November 2021 by monitoring the political/economic events during these months:

Exchange rate in the parallel market LBP/USD



Lebanese lira against the USD dollar: July 2019 to November 2021

Date	EOP	Min	Max	Average	% Δ	Volatility
Jul-19	1,515	1,515	1,515	1,515	0.00%	-
Aug-19	1,600	1,530	1,620	1,572	3.76%	5.73%
Sep-19	1,700	1,620	1,750	1,681	6.93%	7.73%
Oct-19	1,800	1,650	1,800	1,722	2.44%	8.71%
Nov-19	2,150	1,690	2,300	1,900	10.34%	32.11%
Dec-19	2,125	1,950	2,150	2,064	8.63%	9.69%
Jan-20	2,150	2,050	2,530	2,271	10.03%	21.14%
Feb-20	2,470	2,190	2,525	2,364	4.10%	14.17%
Mar-20	2,820	2,440	2,820	2,621	10.87%	14.50%
Apr-20	3,700	2,750	4,200	3,243	23.73%	44.71%
May-20	4,150	3,750	4,350	4,094	26.24%	14.66%
Jun-20	8,600	4,000	8,600	5,244	28.09%	87.72%
Jul-20	7,700	6,200	9,800	8,081	54.10%	44.55%
Aug-20	7,100	6,550	8,600	7,600	-5.95%	26.97%
Sep-20	8,300	7,150	8,500	7,686	1.13%	17.56%
Oct-20	6,852	6,375	8,900	7,803	1.52%	32.36%
Nov-20	4,800	6,950	8,500	7,820	0.22%	19.82%
Dec-20	8,400	7,800	8,525	8,286	5.96%	8.75%
Jan-21	8,880	8,420	8,950	8,762	5.74%	6.05%
Feb-21	9,960	8,800	9,700	9,138	4.29%	9.85%
Mar-21	12,250	9,675	15,000	11,708	28.12%	45.48%
Apr-21	12,350	11,400	13,100	12,201	4.21%	13.93%
May-21	12,850	12,300	13,150	12,713	4.20%	6.69%
Jun-21	17,300	12,925	18,000	15,274	20.14%	33.23%
Jul-21	19,000	16,600	23,300	19,408	27.07%	34.52%
Aug-21	19,000	17,700	21,350	19,587	0.92%	18.63%
Sep-21	17,350	13,650	19,600	16,479	-15.87%	36.11%
Oct-21	21,000	17,400	21,300	19,690	19.49%	19.81%
Nov-21	24,700	20,600	25,700	22,900	16.30%	22.27%

***(Max-Min)/Average x100**

October-November 2019: In these months, the national currency has depreciated by (an average) 10.34% and reached LBP/USD 2,150 at end November. The period witnessed a strong protest on the streets that had resulted in the resignation of PM Saad El Hariri government; furthermore, the banks were closed for as certain period of time and when they reopened, they imposed selective and unofficial capital control leaving depositors uncertain about the value of their placements.

March-June 2020: The national currency witnessed several deteriorations over these months and reached LBP/USD 8,600. An important economic decision was taken by the Government of Hassan Diab on March 2020. It announced that Lebanon can' t service its foreign debt anymore, effectively defaulting for the first time in the country' s history. In consequence, negotiations with the IMF were initiated, but later stalled due to the disagreement between the government, banks, and the BDL regarding the calculation of losses. Unfortunately, the exchange rate was affected negatively and the national currency witnessed a further deterioration.

August 2020: This date witnessed for the first time since the financial crisis, an appreciation of Lebanese lira against the dollar by 5.95%. The France President "Emmanuel Macron" has visited Lebanon after the massive explosion on the 4th of August 2020 and gathered all the political parties in order to from a government that can help Lebanon face the crisis. The political environment after the visits was positive which was reflected positively on exchange rate.

September-November 2020: During this period, there was renewed optimism in the country that saw the exchange rate come down to LBP/USD 4,800. It was characterized by appointing Saad Hariri as PM designate, and a second visit by President Macron to the country promising aid, reconstruction, and reform. The period also benefited from foreign financial support destined to assist victims of the Port of Beirut explosion.

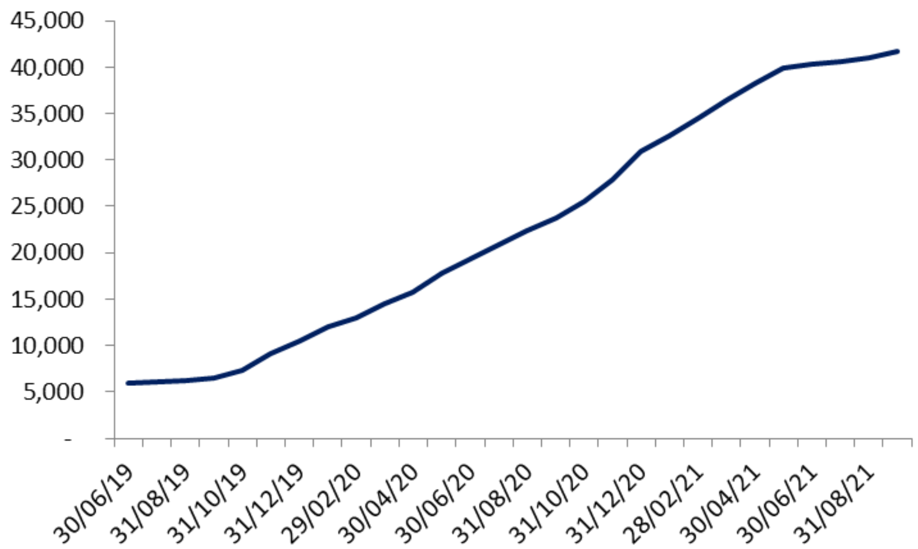
December 2020-July 2021: This period witnessed the end of the "honeymoon". The Macron Initiative was toppled, primarily because of regional resistance, and Hariri faced considerable difficulties in forming a government, mostly by President Aoun. This resulted in further weakening of the exchange rate, such that by July the Lebanese lira witnessed an unprecedented deterioration and slumped by 27.57% to reach LBP/USD 19,000 at the end of this month. On that month too, Hariri stepped down from forming the new government which heightened uncertainty, at a time when the country needed desperately a government to stop the collapse, and reach an agreement with the IMF.

September 2021: This month saw the formation of a new government by the PM Najib Mikati. The market absorbed positively this news. The national currency recorded a good performance and appreciated by 15.87% and reached LBP/USD 17,350 at the end of September 2021. The political environment was promising after the formation of new government, especially as talks with the IMF were rekindled.

October- November 2021: Several major events happened during these two months. Mostly, political conflicts arising from the crises connected with Minister Kordahi and Judge Bitar cast a dark shadow on the economy and paralyzed the workings of the new government, leaving the country in a risk of free fall amid several socio-economic crises. Of course, those unfortunate events had a disastrous effect on the national currency, as it reached all time low to LBP/USD 24,600 for the first time in its history.

Moreover, what has "oiled" these changes in the parallel rate and what was the catalyst behind them? The answer lies in domestic currency liquidity. Primarily because of BDL's Circular 151 -- that allows depositors to withdraw a certain amount from their dollar accounts at the rate of 3,900 LBP/USD – and BDL's partial monetization of the budget deficits, currency in circulation increased from 6.5 trillion LBP in September 2019 to 43.5 trillion in November 2021, or an increase of 570%. This excess liquidity translated to more demand for USD that helped fuel the rise in the parallel exchange rate from LPB/USD 1,700 to 24,300 between September 2019 and November 2021, or a rise of 1330%. And as the FX markets in Lebanon are rather thin, any increase in demand will have a magnified effect on the price; hence the 570% increase in liquidity led to a larger increase of 1330% in parallel market exchange rate.

Currency in Circulation (in billions of LBP)



We have already alluded to the role that platform applications played in the parallel market, but the more important and underlying question is whether speculation has played a crucial part. A speculative bubble exists when an exchange rate (or any asset price) is driven by self-fulfilling expectations rather than by the fundamental variables that normally determine its value. For the bubble to exist, the exchange rate for the Lebanese pound has to exhibit accelerated depreciations, but subsequently it has to experience a sudden and marked appreciation, on the condition that no changes in the fundamentals were observed. The reason is that speculators have to short the parallel market, selling at the "engineered" high parallel market price and in the process driving the price down, but then to buy again at the lower price and as a result making profits from the exchange rate margin. But judging from the table above, these bubbles happened three times only: from June to August 2020 (falling from LBP/USD 8,600 to 7,100); from September to November 2020 (falling from 8,300 to 4,800); and from July to September 2021 (falling from 19,000 to 17,300). More important, these changes were explained by the underlying political/economic fundamentals: the first by the financial support following the Port of Beirut explosion; the second by the Macron Initiative and the Hariri appointment; and the third by the formation of the Mikati government. The upshot of this argument is that the behavior of the exchange rate in the parallel market is consistent with economic/political developments and can be explained in terms of fundamental factors, not so much by speculative pressures. One can even argue that if there were any speculation it was probably informed, as it drove prices towards "equilibrium" values and was in line with fundamentals.

Lastly, the policy relevance of the distinction between whether the exchange rate is driven by fundamentals or by speculative forces is paramount. In the former case, the prescription for undesired appreciation or depreciation is to address the underlying economic/political factors by policy tools. If the exchange rate is being driven by speculative pressures independent of fundamentals and policies, however, the prescription may well be to adopt either a laissez-faire or interventionist approach in the exchange market, the choice depending on the perceived costs of the speculative activity and the size of foreign reserves. In Lebanon, as the former dominates, it is imperative then that it is corrective economic policies and positive political developments that will turn things around in the FX markets and the economy at large.

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