Can Lebanon Turn Around its Export-Based Economy? A Brief Note

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% Change	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	
Real GDP	1.5	9.3	9.1	10.2	8	0.9	2.5	3.8	2.5	0.2	1.5	0.9	-1.9	
GDP Deflator	0.9	3.1	7.5	10.3	0.6	3	7.6	2.6	0.1	3.5	1	2.9	5.5	
Trillion LBP														
GDP	33.2	37.5	43.9	53.4	58	60.2	66.4	70.7	72.6	75.3	77.2	80.1	82.9	
Final Consumption	33	37.2	44.6	51.8	58	61.7	70.5	74.4	77.9	77.8	78.4	82.7	87.8	
Exports of Goods and Services	11.8	13.9	16.9	17.7	20.3	21.9	19.1	18.8	17.2	17.4	16.8	17.5	17.2	
Exports of Goods	4.1	5.4	6.7	6.2	7.1	8.2	8.1	7.5	6.6	5.8	5.7	5.8	5.5	
Exports of Services	7.7	8.5	10.2	11.5	13.2	13.7	11	11.4	10.7	11.7	11.1	11.7	11.6	
Imports of Goods and Services	18.4	22.8	29.9	30.5	34.8	39.6	39.6	42.1	40.6	36.7	35.5	37.2	39.3	
Imports of Goods	13.2	16.7	22.5	22.9	26	30.3	31.1	32.7	31.3	26.7	26.2	27.8	29.8	
Imports of Services	5.2	6.1	7.4	7.6	8.8	9.3	8.6	9.3	9.3	10	9.3	9.4	9.5	
														Average
APC	0.99	0.99	1.02	0.97	1.00	1.02	1.06	1.05	1.07	1.03	1.02	1.03	1.06	1.02
APM	0.55	0.61	0.68	0.57	0.60	0.66	0.60	0.60	0.56	0.49	0.46	0.46	0.47	0.56
Billion USD														
Remittances	5.2	5.8	7.2	7.6	6.9	6.9	6.7	7.6	7.2	7.5	7.6	7.1	7	6.9

Source: CAS and World Bank

In pure economic terms, the Lebanese economy – being a very small and open economy -- can be viewed as following a simple model of economic growth known as export base or economic base theory[1]. Export base theory argues that the economy can be divided into two sectors: the first, is the export or basic sector, which brings foreign exchange that *supports the whole economy by selling goods and services abroad*; the second, is termed the non-

[1] On export base theory, see: Poinsot, P., and Ruaul, J.F. "Economic-base theory and highly-open economies: incorporating day-to- day mobility", *Hal Open Science, August 2019.*

export, non-basic, or local sector, that sells its product within the boundaries of the economy and *exists to support the export sector and largely lives off it*[2].

Traditionally, Lebanon's export base centered on services – mostly: tourism and travel; finance; construction; personal, cultural and recreational; and transport. But the financial crisis, which erupted in October 2019 and continues unabated, has damaged the confidence in this model and even accused it of being rentier or parasitic. Irrespective whether such accusations are true or not, there are frequent and insistent calls now for a new "competitive economic model" that is centered largely on the export of goods, sustained by a wider industrial and manufacturing base[3]. In this sense, the purpose of this short note is to assess the viability of such a transformation and whether the export based model can be turned around accordingly.

We will begin by looking at some numbers for Lebanese exports of goods and services. The Table above records the data from the available National Income Accounts for Lebanon as compiled by the *Central Administration of Statistics (CAS)*, and they run from 2006 to 2018, the latter the last year before the onset of the crisis[4]. Exports of goods and services peaked in 2011 at 21.9 trillion LBP with goods exports reaching 8.2 trillion LBP while service exports amounting to 13.7 trillion LBP. 2011 was the year the Syrian war started, and since then both goods and service exports declined to reach 5.5 trillion LBP and 11.6 trillion LBP respectively by 2018; and the decline in goods exports was more noticeable because the war disrupted trade routes and land crossings via Syria. But it is clear from the table that service exports had always been almost double goods exports; in fact, service exports – unlike goods exports – had always been larger than *service imports*, a rough indicator that Lebanon has or had a comparative advantage in services.

How important are the exports of goods and especially services to the wider Lebanese economy? In more technical terms, how big is the income multiplier related exports? To answer this important question, we will rely on a standard and simple model of the export base theory. If the economy is composed of an export sector (X) and a local sector (L), then income or output Y is equal to:

(1) $Y = Y_X + Y_L$

Where Y_X is income of the export sector and Y_L is income of the local sector. Equilibrium in the local economy equates demand with supply as:

(2) $Y_L = (c-m)\,Y$

Where c is the average propensity to consume (APC) and m is the average propensity to import (APM); and if we assume linear functions then the *average propensities are equal to the marginal propensities*. If we combine equations (1) and (2) together, we get:

[2] The idea applies equally to sub-regions or even cities. The classic example of the latter is New York City, where its main export sector – finance – employs 8% of the labor force but generates 20% of income.

[3] Among others, see: Tawile, J. "After the Crony: A New Competitive Model for Lebanon", *Konrad Adenauer Stiftung*, *November 2021*.

[4] During the studied period, the exchange rate was fixed at 1507.5 LBP per 1 USD.

(3) $Y = Y_X + (c-m)\ Y$

Rearranging the terms in equation (3), we can arrive at:

(4) $Y = 1/(1-c+m)\ .Y_X$

Where 1/(1-c+m) is the export multiplier, and it measures the magnified impact of the export sector on total income for the whole economy. From the table above, APC=c is 1.02 and APM=m is 0.56, which makes the *value of the export multiplier equal to 1.85*[5].

But note that this multiplier is for exports of goods and services *combined*, so we need to disentangle from the export multiplier the multiplier for each of goods and exports. Estimates of the spending multiplier for Lebanon put it at 1.35, and it is not unreasonable to assume this multiplier applies to goods exports as well[6]. Moreover, if we assume correctly that the services multiplier should carry twice the weight of the goods multiplier as service exports are twice the value of goods exports, then a simple calculation will give a *service exports multiplier of 2.12.* As important, *it is larger than the goods exports multiplier of 1.35 since goods exports involve considerable leakages due to raw materials and machinery imports, whereas service exports don't rely on such imports to that extent*. In fact, a service exports multiplier of 2.12 seems to agree perfectly with the limited evidence. According to the *World Travel and Tourism Council Report of 2018,* tourism in Lebanon – a major component of service exports – contributed directly 3.3 billion USD to the economy in 2017 but *direct and indirect contributions amounted to 7 billion USD -- and that implies exactly a multiplier of 2.12*[7].

So we have established that service exports are not only considerably larger than goods exports but they also have a larger multiplier effect on the economy. But that is not all. Another important export in the context of Lebanon is, of course, *labor service exports or expatriate labor*. Perhaps more than a million expatriates work outside the country that, according to the World Bank data in the table above, sent remittances equal to 6.9 billion USD on average over the 2006 to 2018 period. Though the multiplier of remittances is most likely similar to that of the spending multiplier, their value however has been consistent and is quite significant: in 2018, remittances and service exports amounted to 14.7 billion USD (7 billion USD + 7.7 billion USD), almost 27% of GDP; and if one adds goods exports (3.7 billion USD), the amount rises to 18.4 billion USD, about 34% of GDP –no wonder then that the Lebanese economy is considered export based!

If service exports play such a crucial role in the economy, why the clamor to substitute goods exports for it and seek to change the coordinates of the export based model? In the 25 years

[5] That APC is larger than 1 is due to the fact that consumption is larger than GDP, which in turn is because both households and the government in Lebanon are dis-savers whereas only the business sectors are savers.

[6] In other words, it is similar to the spending multiplier arising from consumption and government expenditures. See: Bolbol, A., Hakimian, H., and Mouradian, A. "Macroeconomic Effects of COLA and Salary Scale Adjustments for Lebanese Public Employees", *ABL Monthly Bulletin, No. 2/2016.*

[7] In terms of employment, the *Report* also indicates that direct employment was at 131,500 jobs while direct and indirect employment reached 365,500 jobs, almost 30% of the Lebanese labor force.

between 1950 and 1975, Lebanese service exports were at their apex, considered the best in the region. After the civil war, they managed to do well for another 25 years from 1993 to 2018 but they didn't regain their previous shine. And since the financial crisis erupted in 2019, people seem to have lost faith in the country as an export services hub, in that it is frequently said that tourism, banks, hospitals, universities, ports, media…etc are no longer what they used to be. The sad part is that this would be to some extent true!. A combination of factors endogenous to the country – most notably: poor if not disastrous political governance; misguided fiscal and monetary policies; and the corrosive, disruptive effects of a domineering armed "resistance" – conspired with exogenous factors – primarily the emergence of competing service hubs in the region with outstanding and impressive advantages – to dim the brilliance of the Lebanese service sector that could potentially turn it into a shadow of its previous self.

That said, could the country orchestrate a turnaround centered on a goods exports model? Does it have what it takes to do so? In the economics literature, *comparative advantage is a product of nature and/or nurture*. In other words, it is determined by geography and resource endowments on the one hand, and/or national policies and skills on the other hand[8]. In Lebanon, comparative advantage in services was established early on as the outcome to some of these factors: the country's superb natural location and its strategic location in the Eastern Mediterranean, along with its liberal, open economic policies and the relative education and flair of its population. So realistically speaking, establishing comparative advantage into goods can't be achieved overnight and it is not straightforward at all – we simply do not have the right tools kit for it.

That is not to say that it can't be "created" in a dynamic sense – it can, but the emphasis would *then be on the level of the firms and the establishing of competitive advantage, as comparative advantage at the national level is no longer the appropriate paradigm*[9]. More specifically, the emphasis will be on firms' "created" factors of production and innovation; on firms' demand side, particularly their success in creating differentiated products with some unique characteristics within the same industry; and on firms' gaining a monopoly or niche in the markets for their products. *Thus, in general, the competitive advantage framework relies on the "bottom-up" approach as compared to the "top-down" approach in the models of comparative advantage*[10]. All the while, the success of competitive advantage for goods exports assumes that the right supporting industries, business environment, and government policies are in place. Moreover, and as the latest international evidence shows, the operating environment that underpins this diversification towards goods exports involves four general

[8] By resource endowments we mean labor and capital; and under skills we include human capital and technology.

[9] Since the mid-20th century the most prominent countries who achieved that are Japan and its East-Asian neighbors who followed it in what is called "a flying geese pattern". Needless to say, this is a hard act for Lebanon to follow!

[10] Gupta, S.D. "Comparative Advantage and Competitive Advantage: An Economics Perspective and a Synthesis", *Athens Journal of Business and Economics, Volume 1, Issue 1, 2015*.

pillars: governance, education, infrastructure, and an open trade policy[11]. And in Lebanon, it should also and *necessarily depend on sustained political stability*[12].

To conclude, the export base model fitted the Lebanese economy rather well as centered on service exports, an embodiment of the country's long and deeply-rooted comparative advantage. The financial crisis and the simmering reasons behind it have caused a dent in this service exports model to the detriment of the whole economy. In its stead, there are calls today to adjust the model towards goods exports, partly to increase the country's industrial and technological base and partly to curtail rentier activities. Though such calls could be laudable, they should take guard of two very crucial points: first, goods exports might not have the multiplier effect that service exports have had; second, and more importantly, they are not in line with the country's comparative advantage, requiring the creation of a new competitive advantage which is an uphill and arduous process, if not struggle. As a result, sound but realistic economics would favor a track of *complementing* an upgraded service exports model that has historically served the country quite well with a fledgling goods exports model rather than substituting for it. This will also have the advantage of reversing some of the "labor and brain drain". But the priority or the first order of business before following such a track is to regain fundamentals by rectifying: political corruption, economic mismanagement, armed intransigence, and tense regional relations.

[11] Salinas, G. "How Countries Can Diversify their Exports", *IMF Blog, September 22, 2021*.

[12] Notice that a depreciating exchange rate is not one of the crucial factors to ignite competitive advantage, though reasonable exchange rate levels surely would be. It is interesting that in its latest report on Lebanon *The Great Denial (2022)*, the World Bank asks how come Lebanon's exports did not increase despite a 90% depreciation in its exchange rate? The answer that it provides to this query is that higher exports did not happen because of the inappropriate economic fundamentals and the malignant political/institutional framework – in other words, cheaper exchange rates were ineffectual.

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