

Speculation, Foreign Reserves, and Exchange Rates: A Note on Lebanon



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Year	Average Exchange Rate (LBP per USD)	Foreign Reserves (FR) \$ Billion	Currency in Circulation(CC) \$ Billion	FR/ CC
2018	1,507.5	32.51	3.32	9.79
2019	1,507.5	29.55	6.51	4.54
2020	3,843	18.61	7.61	2.44
2021	12,647	13.64	3.28	4.16
2022	30,473	10.39	2.41	4.31
2023	87,472	9.64	0.58	16.62
2024	89,500	10.13	0.73	13.87
2025	89,500	11.89	0.79	15.05
3/2026	89,500	11.53	0.74	15.58

Source: BDL; CAS

It is no exaggeration that one of the most pressing questions in Lebanon now is whether the exchange rate peg at 89,500 LBP per USD – that has stabilized since July 2023 -- will hold. This is mostly because, given the reductions in remittances and goods and services exports due to the war, the fall in the supply of FX and in BDL's accumulation of foreign reserves could jeopardize the peg, and will primarily be driven by a speculative attack on the Lebanese pound. We want to explore the possibility this happening in the near future. And this is no idle thought, as the Lebanese economy has painfully experienced such outcomes in its recent past when BDL's foreign reserves fell beyond critical levels¹.

¹ See: Bolbol, A., Hakimian, H., and Mouradian, A. 2016. "Exchange Rates and Net Foreign Assets in Lebanon: A Simple Empirical Model", *Association of Banks in Lebanon (ABL) Monthly Bulletin*, No. 7/2016.

To start with, we will first elaborate on the meaning of some of the relevant concepts. A system of pegged exchange rates is usually maintained through the central bank's market interventions using its foreign exchange reserves. Such regimes, however, are subject to periodic speculative attacks, as speculators take a position against a currency if they believe that the exchange rate is likely to devalue from its current parity. Speculators' belief that a devaluation is likely may be self-fulfilling, since the attack motivated by this belief may exhaust the central bank's foreign exchange reserves and leave no alternative but to devalue the currency. And, of course, speculators profit by using the domestic money to buy essentially foreign reserves from the central bank at the fixed exchange rate, and then selling them back into the domestic currency at the devalued exchange rate after the successful attack. *So, to note, it is very crucial for speculation to be profitable that domestic money be available, and preferably at low cost.*

But a more fundamental point is that, under what economic and financial conditions can such speculative behavior succeed. The literature on currency crises associated with speculation is divided into "three generations". The first generation models attribute the speculative attacks to unsustainable fiscal and monetary policies; second generation models to the government's weak commitment to the peg, even if fundamentals are sound; and the third generation models to financial sector fragility, such as balance sheet mismatches and 'moral hazard' from government guarantees².

For those of us who are familiar with the Lebanese crisis, the origin of the crisis is best explained by the first generation models. It was unsustainable fiscal (high public wages and subsidies, along with poor government revenues) and monetary (over-valued exchange rates, and not so limited currency in circulation) policies -- underwritten unfortunately by BDL -- that precipitated the crisis. But it was also tinged with third generation models, when BDL reneged on honoring banks' USD deposits, igniting a collapse in financial confidence, *turning it into a 'twin crisis', currency and banking, but also making the origin of the banking crisis lie with BDL not banks*³.

² All models were formulated after the global move to flexible exchange rates in the early 1970s. First generation models were inspired by the Latin American crisis in the late 1970s; second generation models by the collapse of the European Exchange Rate Mechanism in the 1980s; and third generation models by the Asian crisis in the 1990s. Of course, it is possible, even likely, that crises are the product of a combination of these models.

³ It is actually a 'triple crisis', if we include foreign debt into the picture, as reflected by the Lebanese government's default on its foreign debt in March 2020.

That said, what were the ramifications of these developments on Lebanese exchange rates and foreign reserves? In concrete terms, we can see from the table above, that by 2019, when the exchange rate was still roughly around 1,507.5 LBP per USD, BDL's foreign reserves (FR) stood at \$29.5 billion and currency in circulation (CC) at \$6.5 billion⁴, with the ratio of FR to CC equal 4.5. But this ratio fell to 2.4 in 2020, 4.1 in 2021, and 4.3 in 2022, but to rise to 16.6 at end 2023. And along this period running from 2029 to 2023, the exchange rate depreciated intermittently to 87,472 LBP per USD by end 2023 and, just as important, FR fell to \$9.6 billion at a loss of close to \$20 billion throughout the period. We have shown elsewhere⁵ that of these \$20 billion, \$10 billion went to the blanket subsidies that were unwisely adopted and around \$2.5 billion to support the Sayrafa platform. *This means that speculation at various levels of the exchange rate that BDL tried to support during the period cost a loss of around \$7.5 billion in FR!*

Of course, by the summer of 2023, the policy paradigm turned around, when all the previous malignant policies were eliminated, in addition to the curtailment of CC and the crackdown on the politically-connected foreign exchange companies and apps engaging in speculation and enticing a herd-like run on the domestic currency. And the outcome was fairly benign, such that by end 2025 FR reached \$11.9 billion and CC only \$0.79 billion, while the FR to CC ratio stood at 15 and the exchange rate stabilized at \$89,500 LBP per USD. *Two important lessons can thus be deduced: first, an FR to CC ratio of 4.5 seems to be the critical level below which speculation would take effect; second, higher levels of FR and lower levels of CC, along with strong control and oversight of FX houses, can deter degenerate speculation.*

⁴ We consider currency in circulation as the only part of M1 (LBP liquidity), as LBP deposits at banks were throughout the crisis subject to 'informal' capital controls.

⁵ See: "Seigniorage in the Lebanese Economy: A Tale from the Pre-Crisis and Crisis Years" *Blominvest Blog, Spotlights, February 2026.*

What do these lessons imply concerning the monetary and FX situation that emerged at the beginning of March 2026? Before we answer this question, a note on the ‘new’ BDL would be congenial. Not only has BDL shed its previous role as a fiscal agent of the state, but it is also no longer the ultimate provider of FX for international transactions as trade has become almost totally self-financed. This implies that BDL’s FX responsibilities have finally been reduced. To a large extent, BDL is only responsible now to provide monthly payments of about \$430 million, split roughly into \$250 million for circulars 158 and 166 and \$180 million for public wages⁶. But it is still a notable monthly drain on its FR that it can’t waver from, especially given the reduction of FX inflows arising from lower remittances and goods and services exports because of the war, as can be seen from the fall in FR to \$11.53 billion by end March 2026, and despite that the FR to CC ratio rose to 15.5 at that time.

In answering the above question, we contend that, going forward, the lessons cited above imply the following recommendations are needed to deter speculation and to rescue the peg from harmful speculative devaluations. These, mainly, in an descending order of importance are⁷:

- 1) Increase FR. The government should secure official lending from governments and international agencies⁸. In this respect, social assistance loans from the World bank and liquidity support from the IMF is highly welcomed. Alternatively, if these are not forthcoming, then a partial sale of gold reserves should be considered. BDL has already missed out on liquidating its gold reserves at the high price of close to 5,500 USD prevailing in February 2026, unlike many central banks⁹, so we don’t want to miss again especially if the price recovers. This not only helps BDL to shield from speculators by shoring up FR, but it also helps use gold proceeds to pay back depositors as it covers the \$250 million payments for circulars 158 and 166, and as it answers to the pressing demand by those who disfavor the hoarding of gold.

⁶ So, in reality, BDL didn’t absolve itself fully from being a fiscal agent after all!

⁷ In addition, of course, to the tight crackdown, control, and oversight on the politically-connected foreign exchange companies and apps that would be engaging in speculation.

⁸ This financial assistance is usually transacted at lower market interest rates and involve grace periods on debt service payments, in addition to very long maturity dates. So their debt burden is bot big.

⁹ Central Banks and ETFs sold gold to profit from the high price, which in turn increased supply that helped lower the price; see: “After Iran, gold is looking less glittery: Is the yellow metal the new crypto?”, *Economist*, 4th April 2026

- 2) Stabilize CC. BDL had great success controlling CC since the summer of 2023. This was mainly done by more or less stabilizing CC by injecting CC into the market¹⁰ in tandem with (or in equal amount) to the LBP tax proceeds sucked from the market and deposited at BDL. Thankfully, BDL continues to do that¹¹. An additional measure that BDL could use is to forbid lending in LBP so speculators would be denied leveraged speculation. And if that is not possible, then to impose high interest rates on LBP loans so as to make it costly to engage in speculation by having the higher interest rate margin larger than the benefits accruing from the exchange rate differences.

- 3) Forward Market Intervention (FMI). FMI is a technique that BDL could introduce and use to fight currency speculation without immediately depleting FR. It involves agreeing to sell foreign currency (USD) and buy domestic currency (LBP) at a future date and at a set price, creating a “bear squeeze” that forces speculators to cover short positions at a potential loss¹². Thus by saving FR, creating downside risk, and signaling to the market that BDL is willing to fight, FMI can curb future speculation.

Lastly, of course, the best recommendation is to end the war and eliminate its causes by, first and foremost, disarming Hezbollah. Barring that, it will be very hard for BDL to forestall speculation and exchange rate devaluations for long or on a steady basis. So, added on top of the disasters from the war, we will end up with severe economic pains from the devalued currencies and skyrocketing inflation – what a nightmare! Moreover, in the final analysis, speculation can only cause spontaneous, short-term volatility, but large, long-term devaluations in the LBP are fundamentally linked to political instability, economic mismanagement, and poor competitiveness.

¹⁰ In effect using CC to buy and accumulate FX from the market.

¹¹ This also assumes that tax proceeds deposited at BDL should continue, and even at a faster pace if possible.

¹² A bear squeeze in a forward market is a situation where traders, who have entered into short forward contracts expecting to buy back or settle at a lower future price, are forced to cover their positions at higher prices. When the price rises instead of falling, short sellers scramble to buy, creating a feedback loop that pushes the price higher. In currency markets, central banks may trigger a bear squeeze on speculators by creating a shortage of the currency in the spot market, making it hard for them to fulfill their forward contracts.

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