



January 11, 2020

Contact Information

Chief Economist : Dr. Ali Bolbol

ali.bolbol@blom.com.lb

The ongoing Lebanese economic crisis has brought more to the fore the importance of the current account deficit in perpetuating the crisis. This is because, in the absence of sizable capital inflows to finance the current account deficit, the latter would necessitate depleting foreign reserves for that purpose and endangering the fixed exchange rate regime in the process. So an understanding of the determinants of the current account becomes essential to getting a grip on the crisis. In this spotlight, we will do just that by approaching the current account from the perspective of savings and investment¹.

Let us explain this with the help of the following simple, yet profound macroeconomic relation²:

$(S_p - I_p) + \text{Budget balance} = \text{current account balance}$

The above relation simply says that the excess of private savings S_p over private investment I_p plus the government budget balance (which is itself equal to the excess of public savings over public investment) is equal to the current account balance. Stated differently, the excess of savings over investment generates a current account surplus, whereas the opposite translates to a current account deficit. And, of course, it is deficits that are the hallmark of the Lebanese economy.

How so? The above relation can be expressed in percent of GDP, and the resulting numbers are not pretty. For 2018, a largely representative year, the current account balance was a deficit (negative) equal to 25.5% of GDP. Also, the budget was in deficit at 10.5% of GDP. This leaves us with a negative $(S_p - I_p)$ of 15% of GDP. Given that I_p was 22% of GDP, then private savings S_p was only 7% of GDP! This compares with a world average for S_p equal to 23%. What this means is that private savings in Lebanon – both household and business savings – is 16% less than the world average; in other words, we are very bad savers!

But why does this lead to adverse economic outcomes? Well, with the government dissaving and the private sector “hardly” saving, there is simply too much spending in the economy, and given the limited productive capacity of the Lebanese economy, this excessive spending will translate to huge trade deficits (32% of GDP) and ultimately large current account deficits. Not only we are producing little and buying a lot from abroad, if the economy does not receive enough capital inflows to cover the

¹ Other known approaches are the absorption approach and the real exchange rate approach.

² The standard macroeconomic identity postulates that: (1) $GNP = C + I + CA$, where GNP is gross national product or income, C is private and public consumption expenditures, I is private and public investment expenditures, and CA is the current account.

From (1), we can easily see that if $GNP - (C + I)$ is negative, or income is smaller than expenditures, then the current account is in deficit. Also note that $GNP - C$ is equal to national savings S. Hence (1) becomes: (2) $S - I = CA$. Given that public savings S_p is equal to public revenues R – public consumption C_p , and given that budget balance is equal to public revenues R – public consumption C_p – public investment I_p , then budget balance becomes equal to $S_p - I_p$. Hence (2) can be written as: (3) $(S_p - I_p) + \text{budget balance} = CA$, where S_p is private savings and I_p is private investment.

current account deficits, then the Central Bank will have to pay for the difference through its precious foreign reserves.

So now we know the culprit: low saving rates. But why is that? For households, we want to propose three reasons. First, a cultural reason: the Lebanese love conspicuous consumption and the flare of "keeping up with the Sursuks". Second, a social reason: with the top 10% of households capturing close to 30% of income (perhaps more), the country's income distribution is rather skewed, not leaving much income for the majority middle and lower classes to save from (the figures get a lot worse for wealth distribution). Third, an economic reason: with more than a fourth of the labor force working in the public sector, and given the country's generous public pension system (85% replacement rate, transferable to spouse and unmarried daughters), there is practically little incentive to save for old age.

But what is even more surprising than the low savings rate for households is the low one for business. And we can only conjecture as to the reasons why. First is the predominance of SMEs with limited income-earning abilities. Second is a weak credit constraint, because of the presence of a developed and liquid banking sector (prior to October 2019), which drove firms to access available credit instead of using internal savings. Third, and for large firms, a generous dividend policy perhaps engendered by poor investment opportunities in a weak economy that makes accumulating and investing retained earnings not a very worthwhile endeavor.

As important, what the above discussion shows is that it is not only the government sector that needs to cut deficits and save more, it is also the household and business sectors. For, if the government were to run a balanced budget, then other things being constant, the current account will still have a deficit of 15% of GDP (still sizable) and the saving rates and patterns of the private sector will stay intact. To increase the latter is then of vital importance, and should be on the policy agenda of any reforming government. What is also equally important is the ability to channel these higher private savings to productive investments through a more efficient investment climate (a subject for another spotlight edition).

The beauty of the above approach is that it can also present the current account deficit as the excess of expenditures over income or output (or the absorption approach)³. It then puts the onus on the Lebanese to stop living beyond their means, and to use their savings and business acumen to turn their country around and transform it into a self-reliant, productive, and sustainable economy. In a perverse sense, the current restrictions on bank withdrawals have put a lid on spending and have increased "forced savings". But these are only ad hoc measures with no long-term credibility. Instead, it is by far better to view the current economic crisis as an opportunity – albeit a dismal one – to set up the right structural reforms that would tackle the factors behind low national savings in Lebanon and would allow, however gradually, savings to increase along with their positive implications on internal and external balances.

³ See footnote 2.

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department Bab Idriss,
Weygand Str. POBOX 11-1540
Riad El Soloh Beirut 1107 2080
Lebanon

Chief Economist: Dr. Ali Bolbol
+961 1 991 784

Disclaimer

This report is published for information purposes only. The information herein has been compiled from, or based upon sources we believe to be reliable, but we do not guarantee or accept responsibility for its completeness or accuracy. This document should not be construed as a solicitation to take part in any investment, or as constituting any representation or warranty on our part. The consequences of any action taken on the basis of information contained herein are solely the responsibility of the recipient.