



December 27, 2021

Ms. Tala Nasrallah

Research Analyst

Contact Information

Tala Nasrallah

tala.nasrallah@blominvestbank.com

T +961 1 991 784

Lebanon's public sector and its poor legal system stand ineffectual in tackling corruption amid a slow reform rate and regional instability. In details, underperformance is most prevalent in the trade sector, and with the economic collapse, both weigh down on investors' confidence. As such, Lebanon scores 47.3 out of 100 on Fitch Trade and Investment Risk Index, and ranks 11th place out of 18 among MENA states and 109th globally.

Given that the country depends on imports, the currency collapse and fuel crisis are negatively affecting the demand for imports. In this note, we will tackle the trade sector in its various facets: trade composition, trade partners and agreements, trade subsidized, and trade finance (The note will be based largely on Fitch's report, *Lebanon Trade and Investment Risk*).

Historically, in 2019, 5.6% of GDP was accounted for the manufacturing and export of metals and food products. International demand continues to support the export of high value metals, however, the manufacturing sector will face further cost increases, and shortage of fuel.

As such, Lebanese trade continues to deflate by the second half of the year as the Lebanese Minister of Economy and Trade announced to open up trade with China and to export high quality agro-food for the Chinese market. The export should abide by the international export regulations; however, to this date no update is foreseen.

In turn, the decision of the Lebanese Central Bank regarding the easing of subsidies resulted in a decline in fuel imports, thus prices have increased sharply and resulted in larger electricity blackouts. Furthermore, the outlook for Lebanon's trade environment is negative as it is hard for the existing government to surpass the ongoing trade and currency problems following travel sanctions imposed by gulf state and disruption caused by the unstable political situation. It is mostly unlikely that Lebanon regains its pre-crisis trade level until political deadlock and currency crisis is resolved.

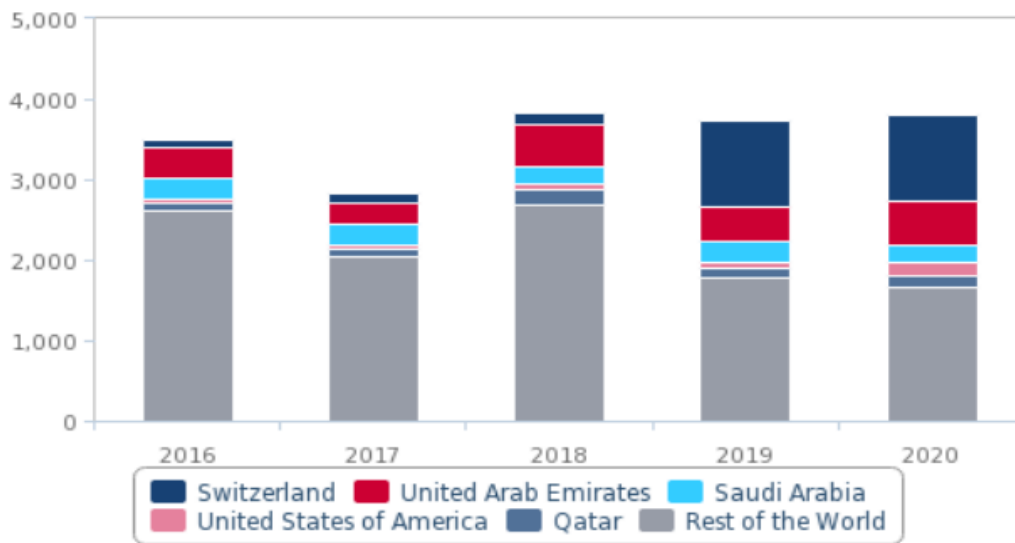
Trade Composition and Partners

As for trade composition, export of metal products (including pearls and precious-and-semi precious stones) constituted 47% of all exports in Lebanon followed by food and agricultural products measuring 19% of exports. The latter is experiencing an inward demand for national production as of the beginning of the crisis; however, the depreciation of the Lebanese currency affects the purchasing power of Lebanese consumers which also adds pressure on the state of the agricultural-sector market.

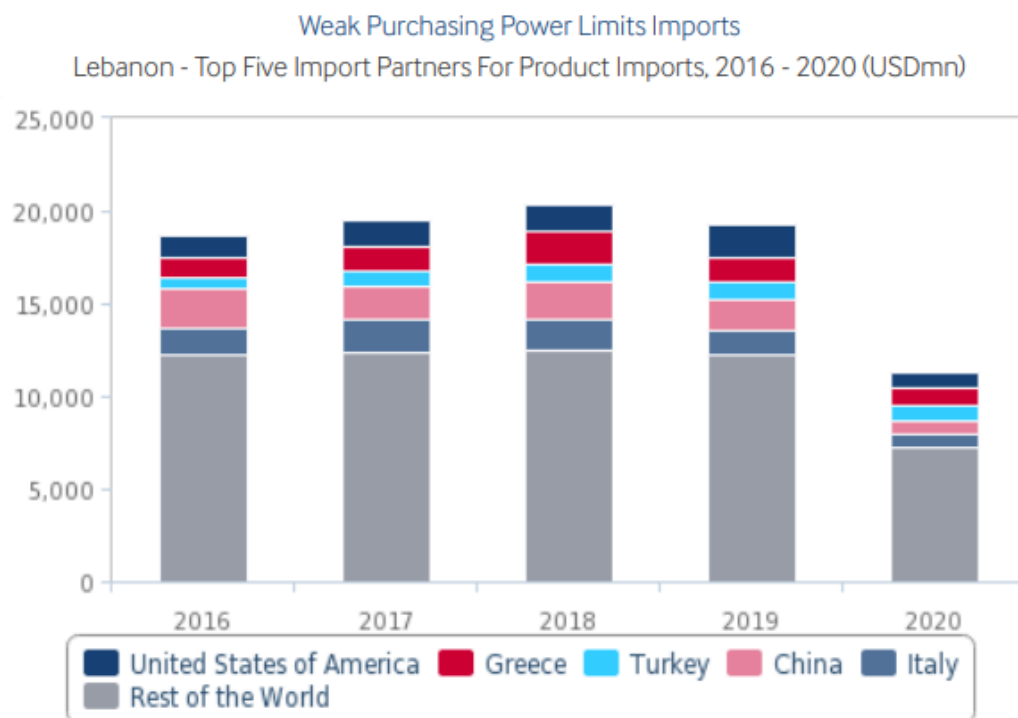
In addition to that, the service sector achieves a major role in Lebanon's economy, with tourism acting as an important factor to GDP. Service sector exports accounted for 80% of total exports in 2019 and is expected to continue for the coming years. Previously, private consumption had made up almost 90% of the Lebanese economy, with imports exceeding exports. As the economic crisis carries on with a weak domestic manufacturing sector, good and fuel imports will continue to exceed exports. According to Fitch Country Risk team, no sign of any significant acceleration in growth is foreseen over the medium term. Furthermore, regional conflicts have made trade from Lebanon very difficult (not to mention the fact that the southern border with Israel is also effectively closed). The fuel crisis has also severely limited road supply chains within Lebanon due to unaffordable domestic transport. These factors have placed increased pressure on the road, port and airport infrastructure in Lebanon, raising the risk of congestion and delays to supply chains and higher costs associated with international trade.

Particularly over 2021, Lebanon's top five export markets pose supply-side risks, with manufacturing and services sectors both suffering. Precious metals, vehicle parts and cosmetics are key export goods to Lebanon's top five well-diversified trade partners. As such, Switzerland reached USD1.1bn worth of exports in 2020, with the main exported goods to include high-value metals such as gold, diamonds and jewellery. Second, financial services and tourism have also historically been key export products to Switzerland, although, with the collapse of Lebanon's banking and tourism sectors, it is expected that trade in those sectors will not resume to pre-crisis levels in the medium term. Other key export partners include the UAE (USD0.6bn), Saudi Arabia (USD0.2bn), the US (USD0.2bn) and Qatar (USD0.2bn).

Historically Diverse Export Market Threatened By Economic Crisis
Lebanon- Top Five Export Partners For Product Exports, 2016 - 2020 (USDmn)



Moving to imports, refined petroleum has typically been the largest import product from the US along with the removal of fuel subsidies in August 2021. Imports with the US accounted for USD0.9bn worth of imports in 2020, with a significant year-on-year decline of -45.2%. However, China previously was Lebanon's largest import partner between year 2016-2018, accounting for USD21bn worth of imports in 2018, then dropped to USD0.7bn in 2020, with a year-on-year decline of imports by -50.6%. Main imports are manufactured products with a lower demand due to lower purchasing power following the depreciation in the Lebanese pound. Moreover, the second and third largest import markets are Greece (USD0.9bn worth of trade in 2020) and Turkey (USD0.8bn) which have also experienced declines in imports. Concluding that the ongoing political gridlock and slight change in Lebanon's economic situation, will continue to be depict weak demand for imported goods.



Trade Agreements

Furthermore, it is interesting to note that Lebanon holds important Trade Agreements which facilitate the operation of trade businesses. Lebanon is a member of the Greater Arab Free Trade Area (GAFTA) along with 16 other MENA states since 1998. The agreement plays a role in eliminating trade barriers between member states and in lowering tariffs. As well, Lebanon holds agreements with the EU and the US for the purpose of establishing full FTAs (Free Trade Agreements). Worth noting that several agricultural and industrial products benefit from the tariff free-market in Greece and Italy, making them stand out as key trade partners.

The political deadlock taking place since August 2021, adds pressure on the previously planned FTAs with the EU and the US and on potential FTA with Argentina, Brazil, Paraguay and Uruguay, a project that initiated in March 2020. As such the table below depicts the GAFTA signed with the MENA and Gulf countries, the EFTA states agreement, the EU and US agreements through highlighting the positive effect of each.

LEBANON - FREE TRADE AGREEMENTS

Country/Bloc	Status	Positive Effect On Businesses
GAFTA - comprising Bahrain, Egypt, Iraq, Jordan Kuwait, Libya, Morocco, Oman, West Bank and Gaza, Qatar, Saudi Arabia, Sudan, Syria, Tunisia, UAE and Yemen	Active	• Moderate: GAFTA was declared within the Social and Economic Council of the Arab League as an executive programme to activate the Trade Facilitation and Development Agreement that has been in force since January 1 1998. • On January 1 2005, the elimination of most tariffs among the GAFTA members was enforced. • Trade liberalisation will reduce the cost of imports to Lebanon; however, regional instability and domestic security concerns have diminished the effect of this agreement and created barriers to regional trade.
EFTA (Switzerland, Norway, Iceland, Lichtenstein)	Active	• Moderate: Switzerland is a key trade partner of Lebanon, although trade with the other member states is much more limited. • The EFTA-Lebanon FTA covers trade in industrial and agricultural goods, the latter covered by agreements concluded bilaterally between each EFTA state and Lebanon, forming part of the instruments creating the free trade area. • The agreement also contains substantive provisions on intellectual property, competition and dispute settlement and covers certain aspects of services, investment and government procurement.
EU-Lebanon Association Agreement	Active	• High: The EU-Lebanon Association Agreement progressively liberalised trade in goods between the EU and Lebanon. • The association agreement is part of the Euro-Mediterranean Partnership which aims to foster trade and investment links between the EU and the southern Mediterranean. • The agreement allows tariff-free access to the EU market for Lebanese industrial and agricultural goods and cheaper access to imports from three of Lebanon's top five trade partners (Italy, Germany and Greece), reducing input costs for Lebanese businesses.
US (Trade and Investment Framework Agreement)	Active	• Moderate: The US and Lebanon signed into force the Trade and Investment Framework Agreement (TIFA), with the aim of regulating all commercial matters between the two countries and strengthening bilateral trade. • This includes a wide range of trade and investment issues such as market access, intellectual property rights and labour and environmental issues. • The TIFA will also help in growing commercial and investment opportunities by identifying and working to remove impediments to trade and investment flows between the two countries. • This will create more opportunities in a key market for businesses in Lebanon.

Source: ITA, US Department of Commerce, Fitch Solutions

Lebanon is not yet a member of the WTO, and this acts as a Trade Barrier to free trade. As such, with no final bound tariff rates set, the government is free to increase tariffs on its own thus standing in the way of trading relationships. Moreover, tariff and non-tariff trade barriers have been kept low, with the average tariff rate on imports standing at a low 3.0%, while customs regulations have been adjusted and aligned with international standards. This doesn't eliminate the fact that corruption and ineffective bureaucracy takes place at borders and unfortunately doesn't fail to stand in the way of previous developments.

Import Tariffs characterized by:

- The average tariff rate on imports of 3.0%, the third-lowest regionally out of 15 countries for which data are available and low on a global comparison.
- Tariffs are highest on fruit and vegetable products and beverages and tobacco, but most intermediate inputs and many finished goods face competitive tariff rates.

Customs and nontariff barriers characterized by:

- There are few non-tariff barriers to trade from Lebanon, with less than 1% of exports and imports subject to additional requirements.

The customs process has been updated to remain in line with international standards, easing the trade process.

Trade Subsidies

Moving to the current Lebanese crisis, it is reflected in a multi-dimensional poverty for almost 77% of the Lebanese households. However, poverty would have been even worse had BDL not subsidized essential products (primarily imports of pharma and minerals) since Q1 2020 till Q3 2021^[1]. But complaints against the subsidies were frequently raised, mostly

^[1]The subsidy involved covering 85% of the cost initially at the exchange rate of 1515 LBP per ¹ USD and then at 3900 LBP per USD. Post Q3 2021 only subsidies on medicines for terminal illnesses have been retained.

because they have resulted in considerable corruption and smuggling, but as importantly because they have wasted precious foreign exchange at a time when poverty would have been better tackled with direct assistance to the poor through cash support programs. We analyze below the impact of subsidies on minerals and pharma imports.

Concentrating firstly on minerals, imports of minerals fell by 37.2% from \$1,586.7 million to \$996.2 million between Q1 2019 and Q1 2020; however, during that period GDP fell (on an annual basis) by 36.5% from \$52 billion to \$33 billion [2]; whereas the price of 20 liters of gasoline at the market exchange rate fell by 33.9% from \$16.2 to \$10.7[3]. So during that period the income effect dominated, and the reduction in minerals imports would have been a lot larger had it not been for the subsidies and lower prices — in addition, of course, for smuggling [4].

Moving on to the Q1 2020-Q1 2021 period (noting that trade data are available up to Q1 2021 only), minerals imports went down by 15.9% only from \$996.2 million to \$837.7 million; whereas GDP fell by 33.3% from \$33 billion to \$22 billion; and the dollar price of 20 liters of gasoline (at the market exchange rate) dropped by 61.7% from \$10.7 to \$4.1[5]. So, alternatively, during the Q1 2020-Q1 2021 period a strong price effect made itself felt (making Lebanon the cheapest country for gasoline prices in the world), almost nullifying the income effect, as the lower price was too good not to indulge in further imports, consumption, and smuggling of minerals.

What about pharma? Theoretically, pharma should be even less responsive (or elastic) to changes in income and prices because it is more of a necessity than minerals (unfortunately, we do not have a representative price for pharma products, so we will do without its

[2] GDP estimates are from the World Bank.

[3] The equivalent prices in LBP were 24,600 to 26,000 at average market exchange rates of 1,511 and 2,418 respectively (information International).

[4] Estimates put smuggling at about 37%. See Blominvest Blog, "Lebanon in Crisis: A Note on Some Economic Issues, Part 2" , Spotlights, October 23, 2020.

[5] For Q1 2021, the price in LBP was 39,700 at the average market exchange rate of 9,869.

quantitative changes). As such, between Q1 2019 and Q1 2020, pharma imports decreased by 20.4% from \$324.1 million to \$257.9 million. So as in the case with minerals, the income

effect dominates here, though as expected the effect is smaller. However, the picture changes noticeably when we move to the Q1 2020-Q1 2021 period. As we can see, during that period, pharma imports increased by 29.9% from \$257.9 million to \$335.1 million, indicating a very strong price effect that more than nullified the negative income effect. One can partly explain the increase in that more than nullified the negative income effect. One can partly explain the increase in pharma products by the spread of the Covid-19 virus and the need to contain it; however, there were less benign reasons behind it. Prime among these is the fact that pharma products are much easier to store (and smuggle), so more of them were imported and stored for speculative purposes in order to sell them at the much higher prices if and when subsidies are removed.

Two conclusions arise from the above discussions that agree with what economic and social science theories have always said about the implications of subsidies. First, they incentivize corruption and waste. Second, they are far better replaced by direct cash transfers to the poor and sick.

Trade Finance

Lastly, it is worth noting that financing of imports and exports through documentary Letter of Credits (LCs) helps maintain confidence for the exporters to ship their goods in advance to the payment. In details, LCs play an important role in facilitating trade dealing among countries and different parties, considering distance, different laws and agreements, and difficulty of knowing and trusting the other party.

	Q3 2019	Q1 2021
Documentary L/Cs		
<i>Opened Credits</i>	1,330,294	20,408
<i>Utilized Credits</i>	1,133,969	27,196
<i>Outstanding Credits</i>	4,092,015	258,035
Bills for Collection		
<i>Outward Bills</i>	360,156	110,654
<i>Outstanding Bills</i>	1,746,596	193,439

On the import side, the buyer or importer of goods opens an LC at a local bank. The bank's responsibility is to ensure that exporter's documents related to the shipment of goods are in order prior to executing the payment. On the other hand, the bank guarantees the exporter or the seller that the second party will pay on time once shipment of goods is fulfilled.

Moreover, data from BDL in the table above, measure the difference in LC volume for Q1 2021 and Q3 2019. We observe that Q3 2019 held a total of 1.3M opened LCs compared to a total of 20.4K in Q1 2021. This reflects both the reduction in trade activity and, perhaps more importantly, the shrinking role and confidence of banks in facilitating trade finance.

Concluding Remarks

Lastly, we note that Lebanon's trade growth is around 1.78% compared to a world growth of 3.50%. Lebanon exports of goods and services as percentage of GDP is 35.36% and imports of goods and services as percentage of GDP is 60.68%.

Trade sector is considered a vital pathway to the country, as it manages to keep keen relations with surrounding countries as well as to add up revenues to the country. However, Lebanon is suffering from its worst economic crisis, as a result, stabilizing the currency is a first step to putting back the economy on track as well as its trade sector.

For your Queries:

BLOMINVEST BANK s.a.l.

Research Department

Bab Idriss, Weygand Str.

POBOX 11-1540 Riad El Soloh

Beirut 1107 2080 Lebanon

Research Department

Tel: +961 1 991 784

research@blominvestbank.com

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.