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For a country like Lebanon, that is open, export based, and global, the balance of payments is perhaps the most congenial mirror that reflects the state of the Lebanese economy. This is especially the case in the past two-and-half years, when Lebanon has gone through all kinds of economic and financial mishaps: currency and banking crises, default, twin deficits, capital flight, import subsidies and smuggling, not to mention severe and worsening rates of poverty. To analyze these painful developments through the prism of the balance of payments, we will look into Lebanon's external accounts -- as compiled by BDL based on the *IMF's 5th BOP Manual* -- for the full year 2020 and Q1 2021 (the latter being the latest published date for the data; see *BDL Quarterly Bulletin Q3 2021* for full date).

The balance of payments (BOP), in brief technical terms and as is shown in the Appendix, is composed of three main items: the current account, the capital and financial account, and unrecorded transactions. In turn, the current account is made up of the *net* sub-accounts comprising goods, services, income, and current transfers. The capital and financial account is mostly represented by the latter, which comprises the net sub-accounts of direct, portfolio, and other investments, in addition to reserve assets. Reserve assets is a most crucial account, as it reflects in a true sense the ultimate balance of payments position since it records changes in the foreign reserves position of the monetary authorities (BDL), with a positive number signifying a BOP deficit while a negative number signifying a BOP surplus (a positive reserve asset, for instance, means that when a negative or deficit balance is obtained from the three items of the BOP, a foreign reserves loss equal to that deficit has to be incurred to turn the BOP to zero). Lastly, unrecorded transactions (or net errors and omissions) is the residual or balancing item that reflects all transactions that were not recorded in the BOP (omissions), as well as all errors made in estimating other BOP entries (errors). As we will see, this item was of considerable heft in the 2020 and Q1 2021 accounts of Lebanon.

We will start with the 2020 accounts in Part I of this note; and then move to compare the Q1 2020 with the Q1 2021 accounts in Part II. From the Appendix we can clearly see the following in 2020: the current account was a negative

\$2,957.1 million; the capital and financial account was a positive 12,888.1 million; and net errors and omissions was a whopping negative of \$9,931 million -- the biggest ever. As important, reserve assets reached a sizable \$13,183 million, so if we abstract reserve assets from the capital and financial account we arrive at a negative or deficit of \$295 million. What this implies is that foreign reserve assets of \$13,183 million had to be incurred to close the deficits from the three main BOP accounts ($-\$2,957.1 - \$295 - \$9,931 = \$13,183$ million)¹. In other words, foreign reserves had to finance the deficits arising from the current and financial accounts and errors and omission, as these were respectively driven by trade deficits, the drying of capital inflows because of government default, and the incidences of capital flight and smuggling. We will analyze these points in some details below.

To elaborate, the uprising that erupted in October 2019 should have resulted immediately in a capital control law, but that unfortunately hasn't happened to this day. To compound matters, the Diab government, in the aim of preserving precious foreign reserves, opted in March 2020 for default on foreign debt. And to add insult to injury, the government instituted in early 2020 a blanket subsidy program on imports so as to ease the cost of living expenses². But, perhaps not surprisingly, all these policy choices have backfired, and instead of preserving foreign reserves, they have actually bled it. It is hard to find a more disastrous menu of policies that only managed to make the crisis even worse, ranking it -- according to the World Bank -- among the most severe that the world has seen in the past 150 years.

It was evident from the Appendix and the discussion above that net errors and omissions assumed a very negative number (or role) at \$9,931 million. We would like to briefly investigate the probable reasons behind this enormity. We will zero in on the financial account, specifically the 'other investments' category³. What strikes you in this category is 'currencies and deposits' on the liabilities side, which stood at negative \$6,232.1 million, signifying mostly deposits that were pulled out by non-residents (fiduciary accounts to a considerable extent). But this item is largely represented at banks by changes in non-resident customers' deposits and in non-resident financial sector liabilities, where the former reached negative \$5,100.2 million and the latter negative \$2,246.2 million, to a total of negative \$7,346.4 million. Hence, there is a discrepancy of more than negative \$1,100 million. On the asset side, the figure is surprisingly positive at \$898.5 million, implying a positive net retrieval of deposits by residents in the midst of the crisis -- a perplexing result to say the least! Looking more closely into this item, it represents mostly changes in the claims on the non-resident financial

¹ In fact, the POB deficit for 2020 shows the *net foreign assets* of BDL at negative \$14,274 million, even higher than the loss in foreign reserves assets..

² Initially, subsidies covered all basic commodities, medicine, and 250 consumer goods. But gradually, they were eliminated, such that by September 2021 and onward (more than one-and-half years later) they only cover terminal and chronic medicine. But that was too late, as by that time BDL had lost close to \$16 billion between December 2019 and September 2021.

³ In the financial account, especially portfolio and other investments, assets refer to resident investments abroad, *recorded as negative when undertaken and positive when retrieved or withdrawn*; as to liabilities, they refer to non-residents investments in Lebanon, *recorded as positive when undertaken and negative when retrieved or withdrawn*.

sector by banks and customers. These stood at positive \$2,051.8 million for banks (primarily money retrieved from correspondent banks), which means that for customers they were a negative \$1,153.3 million (as $\$2,051.8 - \$1,153.3 = \$898.5$ million) and embodying deposits sent abroad by residents. But during 2020, resident deposits in USD withdrawn from the Lebanese banking sector stood at \$4,748.5 million, so to say that only \$1,153.3 million of those was then invested in deposits abroad is a bit of an under-statement, unless the balance was mostly hoarded at customers' homes, which is of course a very likely possibility.

What would additionally explain the huge number for errors and omissions? To answer this question we have to move now to the current account, and more specifically the trade account. In 2020, the trade deficit stood at \$6,499.1 million as imports reached \$9,816.4 million. Of these imports, a total of \$4,372 million were in fuel and medicine, the two main subsidized goods (\$3,188 million for fuel and \$1,184 million for medicine). It was estimated that at least close to 40% of such imports were smuggled⁴, or the equivalent of \$1,749 million. Now, as we have seen earlier, net errors and omissions amounted to negative \$9,931 million in 2020 and the closest that comes to this figure in a normal year was in 2007 when net errors and omissions reached a negative \$5,998.7 million. So it is not unreasonable to say that the ab-normality in the net errors and omissions in 2020 that could be ascribed to the crisis should be around negative \$4,000 million. And as we have calculated before, almost a negative \$1,800 of those can be explained by smuggling and a negative \$1,100 million by capital outflows. That is a total of negative \$ 2,900 million, almost equal to 73% of the abnormal net errors and omissions. Of course, the figure for capital outflows is smaller because there was no capital control law to impede those movements legally and therefore no great need to siphon capital out illegally. Had there been a capital control law, then this figure could have been relatively larger, but overall outflows (especially fiduciary accounts) would have been a lot less, and so would have been the loss of BDL foreign reserves. And if additionally, subsidies were not instituted and a direct income assistance program to the poor was adopted instead, then the loss of foreign reserves would have been by far less, which all makes the management of the crisis the worst imaginable, especially in the early stages that compounded its severity for later on.

The irony is that the government's default on foreign debt was undertaken to save valuable foreign exchange. But not only it had the adverse effects of drying up capital inflows and closing the country's access to international capital markets, it also justified the adoption of other policies, especially those of subsidies. And of course, it had rendered the price of Eurobonds almost worthless. We can detect a sense of that from the Appendix, as debt securities under portfolio investment liabilities stood at \$575.9 million, signifying largely non-residents purchase of Eurobonds as 'vulture investments'; and as debt securities under portfolio investment assets reached \$463.9 million indicating mostly residents' sale of Eurobonds so as to retrieve foreign liquidity. That is at a

⁴ See Bolbol, A, "Lebanon in Crisis: A Note on Some Economic Issues Part 1" *Spotlights, Blominvest Bank Blog*, 16 October 2020.

time when the par value of Eurobonds traded was \$4,425 million implying a price of '23 cents to the dollar' for the defaulted Eurobonds (a total of \$ 1,040 million out of \$4,425 million). The upshot of all this, in retrospect, is that -- by far -- a better policy basket would have involved: no default (but with pre-emptive restructuring talks with creditors); no free capital mobility; and no blanket subsidies; in addition to speedy negotiations towards an IMF program.

Lastly, and to end on a positive note, what eased the economy's and people's hardships was – as it has always been – remittances. These include, as shown in the Appendix, workers' remittances under current transfers and compensation of employees under income. In net terms, the former stood at \$3,780.7 million in 2020 while the latter was a negative \$93.2 million, adding to a total of 3,687.5 million. But given that remittance inflows were \$6,630 million in 2020, then this implies that remittance outflows stood at \$2,943 million – a figure that is to witness a notable decline in 2021, as Part II of the note will reveal.

Analysis of Lebanon's Balance of Payments: Q1 2020- Q1 2021 and the Policies in Between (Part 1)

<i>Appendix: Balance of Payments (Million USD)</i>		2020	Q1 2020	Q1 2021
CURRENT ACCOUNT		(2,957.10)	(1,243.10)	(893.90)
Goods		(6,499.10)	(1,661.90)	(2,262.10)
	<i>Credit</i>	4,096.70	1,067.30	840.00
	<i>Debit</i>	(10,595.80)	(2,729.30)	(3,101.10)
	General merchandise	(7,099.70)	(1,818.70)	(2,208.80)
	Exports FOB	2,716.70	711.60	705.40
	Imports FOB	(9,816.40)	(2,530.30)	(2,908.30)
	Goods for processing	85.40	15.40	30.40
	Repairs on goods	(0.30)	6.30	(1.80)
	Goods procured in ports by carriers	11.70	5.20	1.50
	Non-monetary gold	503.80	129.90	(88.40)
Services		66.70	(201.60)	192.30
	<i>Credit</i>	4,856.00	1,705.10	1,139.10
	<i>Debit</i>	(4,789.30)	(1,906.70)	(946.80)
	Transportation	(806.20)	(245.10)	(219.40)
	Travel	682.20	83.20	233.00
	Communication services	59.80	7.70	15.10
	Construction services	25.30	(6.60)	4.10
	Insurance services	(149.60)	(54.10)	(43.80)
	Financial services (other than insurance)	(277.70)	(73.20)	(44.90)
	Computer & information services	69.00	9.40	6.20
	Royalties & license fees	14.00	4.30	(0.50)
	Other business services	482.10	89.00	240.60
	Personal, cultural & recreational services	(0.10)	(9.60)	(2.70)
	Government services, n.i.e	(32.00)	(6.50)	4.60
Income		(1,044.80)	(210.00)	(84.10)
	<i>Credit</i>	1,590.30	497.60	222.30
	<i>Debit</i>	(2,635.00)	(707.60)	(306.40)
	Compensation of employees	(93.20)	(75.00)	94.00
	Investment income	(951.60)	(135.00)	(178.20)
	From:			
	Direct investment	617.80	130.00	(9.20)
	Portfolio investment	(931.00)	(106.10)	(162.40)
	Other investment	(638.40)	(158.90)	(6.60)
Current transfers		4,520.10	830.40	1,259.10
	<i>Credit</i>	7,750.90	1,748.50	1,899.50
	<i>Debit</i>	(3,230.80)	(918.10)	(640.30)
	General government	(16.40)	(31.00)	7.60
	Other sectors	4,536.50	861.40	1,251.50
	of which			
	Workers' remittances	3,780.70	762.50	976.60
	Other transfers	755.90	98.70	275.00

Analysis of Lebanon's Balance of Payments: Q1 2020- Q1 2021 and the Policies in Between (Part 1)

CAPITAL AND FINANCIAL ACCOUNT		12,888.10	4,777.60	1,880.10
Capital account		1,666.40	431.40	225.50
	Credit	1,815.10	462.80	245.30
	Debit	(148.70)	(31.40)	(19.70)
	Capital transfers	1,702.40	441.40	228.10
	Acquisition/disposal of nonproduced nonfinancial assets	(36.00)	(10.00)	(2.60)
Financial account		11,221.60	4,346.10	1,654.50
	Direct investment	3,002.60	977.00	163.20
		Abroad	(10.50)	(59.60)
		In Lebanon	3,013.10	1,036.70
	Portfolio investment	1,114.30	3,066.30	364.10
		Assets	844.00	682.70
	of which			
		Equity securities	380.10	419.10
		Debt securities	463.90	263.60
		Liabilities	270.30	2,383.60
	of which			
		Equity securities	(305.60)	53.00
		Debt securities	575.90	2,330.60
	Other investment	6,078.20	(1,734.10)	(806.30)
		Assets	403.00	1,955.80
	of which			
		Trade credits	312.00	130.40
		Loans	1,114.50	531.20
		Currency and deposits	898.50	1,708.50
		Other assets	(1,922.00)	(414.30)
		Liabilities	(6,481.20)	(3,689.90)
	of which			
		Trade credits	(264.20)	(127.90)
		Loans	(2,042.70)	(862.10)
		Currency and deposits	(6,232.10)	(3,297.90)
		Other liabilities	2,057.80	598.00
	Reserve Assets	13,183.00	2,036.90	1,933.60
UNRECORDED TRANSACTIONS		(9,931.00)	(3,534.50)	(986.20)

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