How the Lebanon Financial Crisis Could Bleed Through to Other Countries

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This paper examines the profound impact of Lebanon's financial crisis on both the country and its broader economic ramifications for other nations. From the year 2018 till 2021 the country's GDP went from 54 billion to 23 billion, and more than 50 per cent of the GDP has vanished, putting the country back by many years. The research further investigates how the depreciation of the Lebanese Lira, along with the collapse of Foreign Direct Investment which went from 11.1 in 2011 to 2.5 in 2022, and trade deficits that exacerbated economic challenges in Lebanon's trade partners. The findings underscore the interconnectedness of global economies and the significant ripple effects that a financial crisis in one country can have on its trading partners.

Introduction

The paper explores the depths of the Lebanon economic crisis which has been categorised as the worst crisis in the last century by the World Bank. The roots of Lebanon's economic turmoil can be traced back to the late 1990s, with the devaluation of the Lebanese Lira due to the civil war. The nation's economy became heavily dependent on foreign currency inflows, primarily sustained by tourism, real estate, and remittances from the Lebanese diaspora. Remittance played a key part in the reliable source of dollars in the country and it began to fade away in 2011 because sectarian squabbling led to more political sclerosis and much of the Middle East, including neighbouring Syria, descended into chaos. Additionally, there were other political reasons too that led to the worsening of the conditions.

This led the budget deficit to increase and the balance of payments went deeper into the red section as they were finding it difficult to pay for their imports. To tackle the problem of shortages of dollars in 2016 the banks started offering high interest rates for the deposits of dollars, however, it required reforms immediately for the economy to function but it did not happen. This led to improved dollar flows, a climb in foreign reserves and also a rise in liabilities. the government's failure to deliver reforms meant foreign donors held back billions of dollars in aid they had pledged. The final spark for unrest came in October 2019 with a plan to tax WhatsApp calls. Banks no longer had enough dollars to pay depositors queuing outside, so they shut their doors. The government also defaulted on its foreign debt. The currency collapsed, sliding from 1,500 to the dollar before the crisis. This led to the start of the devastating Lebanon crisis.

This paper not only aims to highlight the failure of fiscal policies but also focuses on the spill over effects on other countries by particularly examining the impact on trade patterns and FDI, as well as the subsequent repercussions on other nations. The paper is divided into 5 sections. Section 2 talks about the literature review section which differentiates our paper from already written papers on the Lebanon crisis by other economists. Section 3 is the country profile which gives background about Lebanon and shows the impact of the crisis through GDP, Unemployment, and Inflation. It compares the crisis condition of Lebanon to other countries and draws the conclusion on the severity of the crises. Also, it highlights how inflation and the labour market of Lebanon can affect other countries' performance and other sectors. Section 4: is the spillover section which straightforwardly brings out the effect of the Lebanon crisis on other countries through trade and FDI and also connects the unemployment and inflation spillover effect. Section 5 is the conclusion which summarises the paper and shows our research findings. We would compare the Lebanon crisis with other crises in the countries which are categorised in the same economic segment; after this, we show the spillovers of the Lebanon crisis to other countries through the use of trade and FDI. Lebanon was a major exporter to a few countries and a major investor but due to the crisis, they could not maintain the level of trade and investment which led to major problems arising in those countries like a rise in the unemployment rate and a drastic drop in the value of GDP.

Literature Review

A financial crisis is a disruption to financial markets in which adverse selection and moral hazard problems become much worse so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities. As a result, a financial crisis can drive the economy away from an equilibrium with high output in which financial markets per-form well to one in which output declines sharply. There are several reasons why an economy can lead to a financial crisis like fiscal policy failure, political instability, and pandemic.

Claessens and Kose (2013)[1] discussed the causes and impacts of the financial crisis. The paper talks about 4 different types of financial crises: currency crises, sudden stops, foreign and domestic debt crises and banking crises. There are 3 different types of crisis present in the Lebanon case. A Currency crisis happens due to the currency resulting in a devaluation (or sharp depreciation), forcing the authorities to defend the currency by expending large amounts of international reserves, sharply raising interest rates, or imposing capital controls. A foreign debt crisis takes place when a country cannot (or does not want to) service its foreign debt. It can take the form of a sovereign or private (or both) debt crisis. A domestic public debt crisis takes place when a country does not honour its domestic fiscal obligations in real terms, either by defaulting explicitly, by inflating or otherwise debasing its currency, or by employing some (other) forms of financial repression. Guechati and Chami (2022)[2] highlight a description of the Lebanon crisis in certain aspects like currency crisis, exchange rate, and public debt.

Country Profile

Lebanon's economic crisis, one of the most severe in modern history, is rooted in a combination of long-standing vulnerabilities across several key sectors. The crisis traces back to the late 1990s when the Lebanese Lira was devalued during the civil war. Post-war, Lebanon's economy became heavily dependent on foreign currency inflows, including remittances, tourism, and real estate investments, which were crucial in maintaining the currency peg. After understanding the root cause of the problem and the prolonged history of Lebanon's history let's dive into the three main aspects of GDP, Inflation, and unemployment to learn about the effects and intensity of the crisis.

Economic Growth

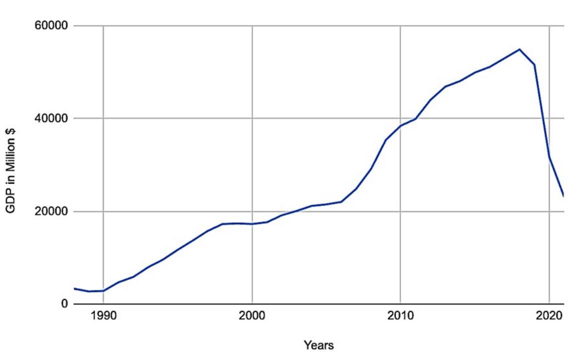

Fig. 1 GDP of Lebanon
Source: The World Bank.

In Fig 1 we can see that since the civil war was over in 1990 the economy was stable and had been growing at a steady rate but then in 2015, there was a sudden stop in the growth rate. GDP growth is estimated to have slowed to 2.5 per cent in 2012 and 1.5 per cent in 2013, from an average rate of 9 per cent in 2007-10. This happened in 2016 as it was Lebanon's first real slowdown in foreign inflows: Between May 2015 and May 2016, the dollar liquidity of the country decreased for the first time in 11 years. As a result, the central bank of Lebanon initiated a series of financial engineering operations which became known in the press as "the swap "The central bank exchanged public debt it owed in Lebanese pounds against Euro bonds, or debt labelled in foreign currency, for the equivalent of US$2 billion. Between June and October 2016, the central bank exchanged these Eurobonds against actual foreign currency with a selection of commercial banks. As a result, the Lebanese economy managed to avoid the consequences of a liquidity crisis at the time, but it increased the public debt considerably in dollars and cost the entire economy a fortune: the international monetary fund 2 estimated that the banks that took part in the operation made US$5 billion while the central bank pull-out cost was US$13 billion in foreign currency. However, the government's failure to do economic reforms has led the economy to continue to fall and a drastic fall is seen.

The fall was so significant that GDP went from 54 billion in 2018 to 31 billion in 2020 and then to 23 billion in 2021. Since 2018 more than 50 per cent of the GDP has vanished highlights the severity of the crisis. The crisis has pushed the economy back 17 years, in 2006 they had almost the same GDP 22 billion. To understand the crisis more thoroughly we can take a look at other countries who suffered from fiscal crises through the comparison of GDP. The first one would be the Russian crisis from 1992 to 1997. From the start, they had a declining GDP rate till 1997 but at a very slow rate unlike Lebanon and even in 1998 when the dip came it was not as severe as Lebanon. GDP went from 404 billion to 270 billion which is almost 32 per cent but in the Lebanon crisis, the GDP had dipped more than 50 per cent. Thus, the Lebanon crisis was severe. If we take a look at other countries that are categorised in the lower middle economy class by the World Bank, no one of them had such a severe fall in 2018. The countries Jordan and Qatar since 2016 had a growing GDP. In 2016 Jordan had 39 billion dollars Qatar had 151 billion dollars and in 2020 they had 43 billion and 144 billion dollars (World Bank)[3] This shows that Lebanon was the only one that was severely affected by the crisis.

In 2022, the gross domestic product in current prices in Lebanon increased by 1.3 billion U.S. dollars (+6.35 per cent) since 2021. In total, the GDP amounted to 21.78 billion U.S. dollars in 2022. The growth highlights that the economy was reviving and getting back to normal but at a very low pace. Though they had a billion-dollar increase by adjusting to inflation it would not be much. Thus, the impact would take at least

5 years for the economy to get back to normal. A declining GDP preceded this increase. 23.13 USD Billion by the end of 2023, according to Trading Economics global macro models and analysts' expectations. In the long term, Lebanon's GDP is projected to trend around 23.82 USD Billion in 2024 and 24.66 USD Billion in 2025,

Now if we look at the economic growth of Lebanon and compare it to other countries that are categorised in the same lower middle economy, and are in the same region like Qatar and Jordan:

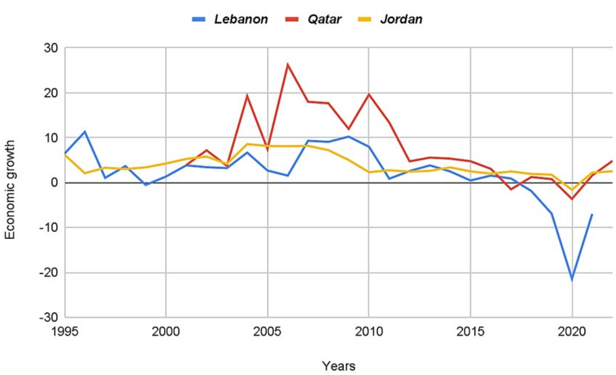

Fig. 2 Economic Growth of Lebanon
Source: World Bank.

The graph shows the economic growth of Lebanon, Qatar, and Jordan. Qatar since the start has had very unstable economic growth but Jordan and Lebanon have quite similar trends. Their starting point was the same and their graph intersected many times showing their growth rate were very similar. Moreover, even Qatar also joined their trend pattern after 2012. The pattern continued for 5 more years and in 2017 if we look at other countries, the economy remained the same but Lebanon took a dip while the other countries' economies remained the same. Then in 2019, we can see a dip in all three countries but Lebanon has a drastic fall due to various reasons like Covid-19 and the ongoing economic crisis accompanied by the Beirut incident. After the crisis, we can see other countries quickly regaining their economic base within two years but still Lebanon is in the negative economic growth section showing the incident's impact on them.

In order to understand the reason Lebanon suffered the drastic drop in economic growth we are analysing three major parts of the economy which have played a vital role in this crisis. Firstly, the Banking Sector: Central to Lebanon's economic model, the banking sector has been a significant contributor to its financial stability. The system attracted substantial foreign deposits due to high interest rates. However, this model collapsed when foreign inflows dwindled post-2015, leading to a liquidity crisis. The central bank's financial engineering tactics, including debt swaps, only increased public debt and depleted foreign reserves, culminating in a sector-wide collapse that eroded public trust and investor confidence. Secondly, Remittances from the Lebanese diaspora and foreign aid have been vital to Lebanon's economy, particularly in supporting household incomes and offsetting the trade deficit, however, they also started to dwindle due to the slowness of the government's action making the investors pessimistic. Thirdly, Real Estate and Construction Sectors: These sectors, once major contributors to GDP and employment, have also been severely affected. The economic downturn led to a collapse in real estate demand, driven by the depreciation of the Lira and declining foreign investment. This downturn cascaded into the construction sector, leading to widespread job losses and halting many projects which are further discussed in the unemployment section of the paper. The real estate collapse further strained the banking sector, given its exposure to property loans and the difficulty the banks faced in recouping the money from the lenders even worsened their situation. Lastly, Political Instability and Economic Mismanagement: Chronic political instability and corruption have paralyzed economic reform efforts. The inability to implement necessary economic reforms, coupled with inefficiency and power struggles, has driven away foreign investors and left the economy in tatters. The 2020 Beirut port explosion further exacerbated the situation, causing massive infrastructural damage and deepening public distrust in the government. In addition to Lebanon's economic mismanagement and financial instability, the country's crisis is also deeply rooted in widespread corruption and political instability. Corruption has long been embedded in Lebanon's political system, with elite factions benefiting from state resources while neglecting essential reforms. This corruption has eroded public trust, hindered governance, and fuelled social unrest. Political instability, exacerbated by sectarian divisions, has made it difficult to form effective governments capable of addressing the growing economic crisis. The influence of external powers such as Syria, Iran, and Saudi Arabia has further complicated Lebanon's internal affairs. These nations, each with vested political and economic interests, have backed different factions within Lebanon, thereby increasing internal divisions and prolonging political paralysis.

Syria's ongoing civil war, for instance, has contributed to economic pressures by flooding Lebanon with refugees and destabilizing the region. Meanwhile, Iran's support for Hezbollah has increased tensions with Saudi Arabia, further polarizing Lebanon's political landscape. These external influences have delayed crucial economic reforms and deepened the crisis. Collectively, these factors—corruption, political instability, and external interference—have not only hindered Lebanon's recovery but also amplified its socio-economic challenges, making a resolution to the crisis more complex and urgent.

Unemployment

The fall in economic growth and the drastic drop in the GDP brings another problem with it rise in unemployment. During the crisis, Lebanon faced a rise in unemployment in many sectors like tourism and manufacturing sector. The graph of unemployment in Lebanon can be seen below.

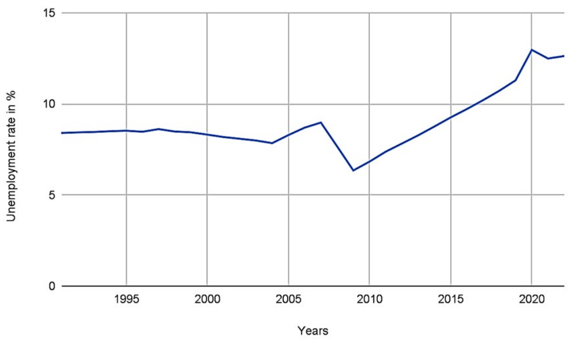

Fig. 3 Unemployment rate in Lebanon.
Source world bank[2]

Lebanon had a rising unemployment rate since 2010 due to the spillover effects of other countries around it. The civil war in Syria which started in 2011 and still going on had a significant impact on Lebanon. Security developments in Syria have disrupted the goods trade. Goods exports have declined as land ports used to export goods to the MENA region (most notably fresh fruit and vegetables) have seen substantial drops in activity which had an impact on the unemployment rate. Furthermore, imports of goods have seen limited growth over the same period. Also, import demand associated with the increase in Syrian refugees has likely more than offset a shift of import composition toward items with lower values ("flight away from quality"). The deterioration in security has also affected the tourism sector. The sector mainly depends on the large Lebanese diaspora and [insert the full name here (Gulf Cooperation Council) countries for most of its business.

The conflict in Syria blocked all land routes to Lebanon for GCC visitors. Moreover, GCC countries issued travel warnings to their citizens against visiting Lebanon starting in 2012. In 2013, tourist arrivals were 60 per cent of their 2010 level. Hotel occupancy rates as of 2013 were 51 per cent, compared to 68 per cent in 2010. Lebanon is a country heavily dependent on tourism. The current account deficit remains large, at about 13 percent of GDP both in 2012 and 2013.

Amongst the various reasons for the rise in unemployment in Lebanon, the most important was tourism. In all, lower tourism and trade caused the local businesses to have fewer businesses forcing them to slowly fire the people and the decrease in remittance along with the increase in refugees led the government spending to be used for that. This shows that the decline of tourism country throughout these years contributed to the slowdown of the GDP growth in the country. It also brought in the inflow of dollars into the country so a decline in it also contributed to the impact of the decline in foreign currency inflows. Moreover, the increase in the unemployment rate also contributed to the decline in GDP as it reduced the disposable income of the people making them fewer goods. Thus, the reduction in foreign currency flow had a compounding effect in decreasing the GDP.

Moreover, the government tax revenue was even less in those years. For instance, VAT revenues for hotels and restaurants as a per cent of GDP fell by 27 per cent in 2010–13, whereas VAT revenues for retail trade fell by 10 per cent during the same period. This shows that even the government spending decreased as the income tax fell due to unemployment and the decline in tourism had an impact on direct taxes leaving the government in a much worse position. Thus, the government had such a sharp decline in GDP and also it highlights the incapability of the government to increase employment due to the fiscal deficit. In 2020 almost one 1 in 8 people in the economy was unemployed. If we take a look at other countries like Qatar, instead of having a rise in unemployment rate they have had a fall since 2011. Their economy's unemployment is falling and in 2018 it was just .1 percent. However, if we take a look at Jordan they had a high unemployment rate, in 2018 it was 18.3 percent even higher than Lebanon shows that other countries were too facing a crisis. If we look at Russia during the 5 years they also had the same unemployment rate as Lebanon, 13 percent in 1998 when they were suffering from the fiscal crisis. This shows that the Lebanon crisis was equal to Russia but also more severe.

Inflation

During a crisis, one of the major factors is to look at the inflation rate of the country as it has adverse effects on the country too. The graph of Lebanon's inflation rate.

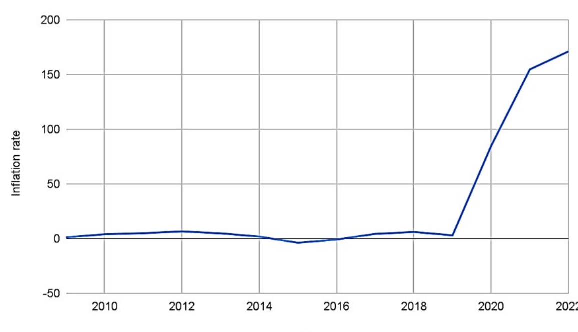

Fig. 4 Inflation in Lebanon.
Source: World Bank

A low inflation rate exhibits an increase in the currency rate and an increase in the purchasing power of individuals. Individuals in Lebanon are struggling with the rise in living costs amid the economic crisis. When inflation is high, the cost of living increases and contributes to the deceleration of economic growth. Moreover, with the rise of inflation and less purchasing power people contain, unemployment rises as the AD falls making the unemployment rise in the economy. This is also contributed by the worsening of the balance of payments due to inflation. The fall in the local currency affects the dollar circulation in the economy. Hyperinflation has severely affected the people of Lebanon, especially the impoverished communities. Political corruption and reduction in government tax revenue due to the decline of GDP and unemployment have contributed significantly to hyperinflation in the country. The Lebanese citizens were frustrated with the government's actions in 2019 since they suffered from power costs, limited healthcare, minimal access to clean water, and poor internet connection. The prevalence of severe food went from insecurity in the population to 12.6% (World Bank)[4] and the prevalence of undernourishment to 11%. This highlights that the public barely had food and access to their basic needs due to the rise in inflation and was suffering from severe problems. the rate of inflation in the country in 2022 Feb was almost 171% (World Bank)[5] which shows that the savings and fixed-income people would have suffered as every second their value of money was decreasing. On the other hand, if we look at countries like Lebanon, Jordan did not face such severe inflation according to the figure given below. They had a stable inflation rate of 4.5 and .8 in 2018 and 2019. The same goes with Qatar they had .3 per cent inflation in 2019 and -.7, -2.5 in 2019 and 2020 World Bank. This shows Lebanon was the only one which suffered from such a horrible crisis. If we look at the Russian crisis it had 800 percent inflation but during the crisis, it dropped drastically unlike the Lebanon crisis by the end of the crisis it was back to the rate of 18 percent.

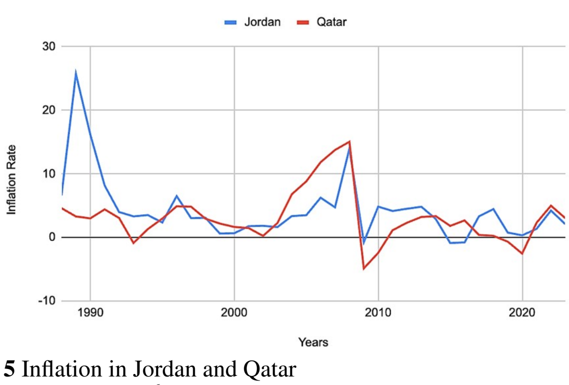

Fig. 5 Inflation in Jordan and Qatar
Source: World Bank[6]

SpillOvers

Spillovers are affects the other country faces due to the crisis happening in other countries. The main reason for the spillovers is globalisation. In recent times countries have become very connected and dependent on each other. In this, we will analyse the effect on other countries through trade, and FDI which were severely affected due to the Lebanon crisis.

The measures we discuss above like unemployment and inflation can also have spill effect on other countries. The rise in unemployment can make the people emigrate from the country putting resource pressure on other countries. This can be even seen as the net migration rate has been negative since 2015 -223,722 in 2015 and in 2023 -177,331. This indicates the pressure another country might have to suffer due to the crisis.

First, I would look at the trade of Lebanon crisis and how its current account balance would have affected other countries. Lebanon had a rather stable current account balance. This rise would have impacted the trade partners of Lebanon. The bar graph below illustrates Lebanon's imports and exports. The blue part shows the imports and the red part shows the exports. We can clearly see that as the price of the Lebanese lira is depreciating, the overall percentage of exports is increasing and imports are falling. So, Lebanon's main export partner has been the UAE for many years, and most of the trade is of consumer goods like raw materials over the years. Thus, this crisis had an adverse effect on many industries in the UAE. Due to the social unrest and devaluation of the currency Lebanon's exports were reduced hampering the supply of Lebanese jewellery and raw materials like gold and gems to the UAE, particularly Dubai which led merchants to suffer from shortages and lose business. Not only this they lost on the exports to, many merchants re exported the the diamonds and merchants to India and Switzerland after giving them their own cultural touch. Thus this led to a worsening of the balance of payment and a rise in unemployment in UAE which showcases the spillover effect of the Lebanon crisis. On the other hand, its major importers are China and Greece and the major imports are petroleum and gas. However, in 2017 they had exports of 8 billion US dollars and more than half was to the Congo Republic which is surprising even for the imports the regular countries whom they used to import the most were not on the top it was from Syria 41 billion 29.57 of the entire trade and then China of 15 billion 10.96%. Since 2010 Syria's economy has been falling down. In 2016 it got to 12.6 billion from 252 billion but in 2017 it saw an increase from 12.6 to 16.31 which is not a lot but still the exports to Lebanon would have helped in the contribution to its GDP. However, in the next year, the imports had a drastic fall and went to 19 billion and if we see there were no imports from Syria and the imports from China had also fell from 15 billion to 2 billion which clearly shows the crisis impact on their economic growth and unemployment rate in the country. World bank 1

The reason for this change in the current account balance was the collapse of the exchange rate. It made commodities very expensive for foreign markets to buy Lebanese goods. Lebanese currency has vanished. The effective exchange rate has collapsed by nearly 95% in two years and domestic inflation has skyrocketed: Annual consumer price inflation in Feb. 2022 reached 215%. Food price inflation is nearly double that figure: 396%. IMF 2, Thus it was very difficult for the country to export goods and the imports were rising making it difficult for them to survive in the current account deficit. This would have an impact on the major importers of Lebanon like China and Greece. If we see in 2018 china had only 10 percent trade with Lebanon in 2019 8.45 per cent trade and then in 2020 6.45 per cent. This shows that due to the crisis, Lebanon is importing less as the majority of the country cannot afford goods due to hyperinflation pushing them below the poverty line. As a result, the importers are losing market share. This can also be the reason that the exports are rising due to the crisis. People are unemployed and do not have money to spend. The country is trying to export surplus goods to other countries.

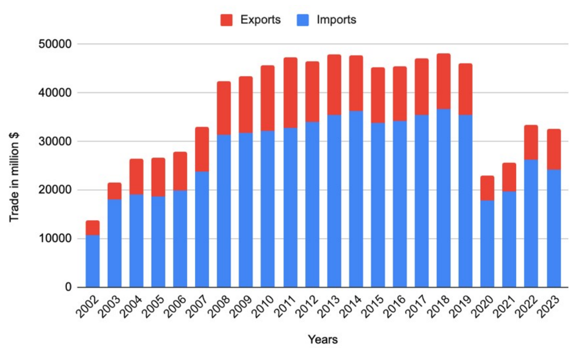

Fig. 6 Lebanon's Imports and Exports
Source: World Bank[7]

The other spillover would be through FDI. Now, if we look at the FDI of Lebanon over the past few decades it has been rather unstable.

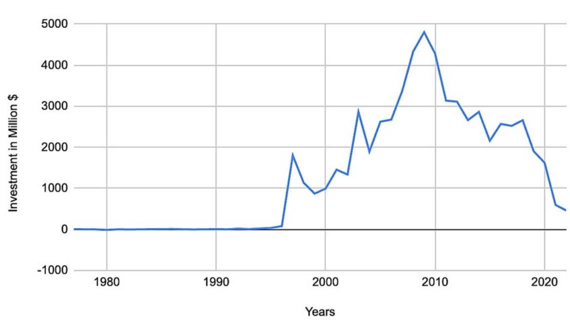

Fig. 7 FDI in Lebanon Source: World Bank[5]

The graph represents the FDI of Lebanon over the years. Foreign direct investment refers to the purchase of an asset in another country, such that it gives direct control to the purchaser over the asset. There are several benefits of having an FDI. FDI allows the transfer of technology—particularly in the form of new varieties of capital inputs—that cannot be achieved through financial investments or trade in goods and services. FDI can also promote competition in the domestic input market. Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country. Profits generated by FDI contribute to corporate tax revenues in the host country. The graph clearly illustrates that in 1995 due to post-war construction Lebanon had a spike in FDI and since then it has been growing for a while. However, after 2018 there had been a drastic drop and it had continued to fall after that. Lebanon had been a major investor in many countries like the USA 10%, Qatar 10% of total FDI and Syria throughout the decade but the economic crisis would have resulted in less FDI in investment in these countries having an impact on them too.

The graph below shows the graph of Lebanon's FDI outflow which has been declining. This would have impacted countries like Qatar and Jordan. Global foreign direct investment (FDI) flows in 2021 were USD 1.58 trillion, up 64 per cent from the exceptionally low level in 2020. This shows that Lebanon not investing in the country Qatar and the Covid-19 had a drastic impact on the country. If we see Figure 4 we can see Qatar had a drop in economic growth due to Covid-19 and less in FDI. Due to the decrease in FDI in the country, the tax revenue gained was less thus the government sledging which led to the fall of GDP. GDP went from 176 billion to 144 billion which is approximately an 18 percent drop in the GDP due to this the unemployment rate rose by 0.4 percent. If you take a look at Jordan they also faced the same issues. They were also one of the main investors in Lebanon. Jordan had 2.03 billion as net inflow of FDI in 2017 but in 2018 they only had 954 million dollars which is a drop of over 50 per cent. As FDI decreases tax revenue and also impacts the technology of the country this leads to the fall of GDP and also the impact on the labour market. The unemployment rate in Jordan has been increasing since 2016. It was 15 percent in 2018 and then in 2017, it went to 18 percent which shows that the Lebanon decrease in FDI had an impact on the labour impact. This would have also resulted in increased pressure on the government as now more unemployment benefits would have been withdrawn increasing the opportunity cost.

Conclusion

The paper explains the reason for the Lebanon crises Lebanon's economic trajectory since the late 1990s was marked by dependence on foreign currency inflows from tourism, real estate, and remittances, which unravelled amid political instability and mismanagement. The Gulf region's political turmoil and the subsequent decrease in remittances exacerbated the crisis, with Iran's influence rising. The failure to implement economic reforms and the catastrophic events of 2020, including the Beirut port explosion and the COVID-19 pandemic, culminated in what the World Bank termed the third most severe crisis since the

1800s.

Analysing the crisis in detail, the research employs graphs illustrating Lebanon's GDP decline, rising unemployment rates, and hyperinflation. It explores the severe impact on the country's population, including increased poverty rates and food insecurity. Moreover, the study extends its analysis to compare Lebanon's economic indicators with those of countries in similar economic segments, highlighting the severity of Lebanon's crisis.

The research accentuates the spillover effects, illustrating how Lebanon's crisis reverberates through trade patterns, exchange rates, and FDI. Through examination of trade balances, the study reveals the disruption caused by Lebanon's economic downturn on its trade partners, affecting both exports and imports. The FDI graph underscores the loss of confidence among foreign investors, contributing to Lebanon's economic challenges. However, the research paper also has some limitations: the paper is focused on the usage of simple data from the World Bank and the IMF further intricate research can be done through the usage of panel data regression and vector auto-regression. Furthermore, the research does not take in consideration certain channels in spill like migration and remittance which can be included to get a better understanding of the impact on other countries.

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