

Evaluating The Peg in a Small-Open Economy The Case Study of Lebanon



The Lebanese Pound is the national currency of Lebanon.
1 U.S. Dollar = 1507.5 LP

Summary

The choice of an exchange rate in a small-open economy is perhaps the most important economic decision the government or central bank has to make. The fixed exchange rate regime is the most common in developing economies, but it is not always the best. Using Asim Husain's template for assessing the peg, I conclude that the central bank in Lebanon has sufficient evidence to support the 10-year-old peg. However, pegging the Lebanese pound solely to the U.S. Dollar may become risky in the near future. Therefore, I recommend a movement towards a basket peg that includes both the Euro and the U.S.D.

Central banks have to choose an exchange rate policy depending on factors such as economic and financial integration, economic diversification, and monetary stabilization. The exchange rate derives its importance from its influences on the competitiveness of domestic products in international markets. In addition, the exchange rate can affect the government's budget by setting the price at which it purchases foreign currency. In other words, the exchange rate is the link between the domestic economy and the rest of the world economy.

The Fixed Exchange Rate:

The central bank (CB) assigns a fixed price of a foreign currency in terms of the domestic currency called the parity. This system requires large foreign exchange reserves in order to defend the announced price. The foreign currency is usually that of a major trading partner, but if a country has more than one major trading partner, the CB can choose a basket peg. In general, a fixed exchange rate lowers transaction costs between trading partners and encourages investment.

- Advantages of such a system include preventing destabilizing speculative activities, increasing transparency and credibility, and promoting growth through low inflation and stable financial markets.
- Disadvantages include the risk of a currency crisis resulting from low levels of foreign reserves. Also, if the central bank maintains low interest rates when markets are expecting a devaluation, capital will flow out of the country. In other words, some of the control over monetary policy is lost.

The Case Study of Lebanon

A country with high economic integration can benefit from the peg by decreasing transaction costs. Lower transaction costs encourage trade and promote foreign investment thus leading to faster economic growth. However, with trade averaging 53% of GDP (Figure 1), Lebanon is not fully economically integrated.

Therefore, based on economic integration, both a peg or a no-peg exchange rate policy have the same effect.



Source: Ministry of Economy, International Financial Statistics

Figure 1

The volume of trade is not enough to describe Lebanon's economic integration. As Figure 2 shows, most of Lebanon's exports are destined to countries where the U.S.D. is the national currency or to which the national currency is pegged. This export concentration provides support for the peg since pegging to the currency of the



major partner would limit transaction costs. However, a growing percentage of trade is with Euro currency areas which may undermine the importance of the Dollar as a sole currency anchor.

Figure 2

Source: BLS/STAT, IMF

Furthermore, given the large volatility of the terms of trade (Figure 3), a more flexible exchange rate would lead to adjustments that insulate Lebanon from large fluctuations. Therefore, this provides a case against pegging the Lebanese Pound to the Dollar.

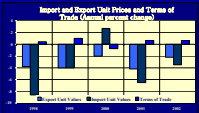
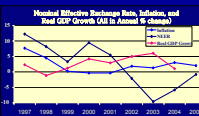


Figure 3

Source: Ministry of Economy

The low correlation between the effective exchange rate and both inflation and real GDP growth indicates a low "pass-through" effect of changes in the exchange rate on prices and production. As a result,

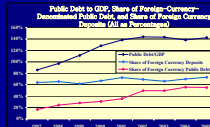


having a peg or not does not jeopardize economic growth nor does it necessarily promote it.

Figure 4

Source: World Bank, IMF

The large sums of dollar-denominated debts by the government present a strong case for a peg to the Dollar as an exchange rate depreciation would cause a large "pass through" effect possibly leading to a recession. As



shown in (Figure 5), the Lebanese economy is highly dollarized, it is too risky not to peg.

Figure 5

Source: International Financial Statistics, World Bank

Lebanon		Scoreboard
Economic Integration		Neutral
Trade orientation		Neutral
Trade partners concentration		Case against peg
Cyclical synchronicity with trade partner		Strong case for peg
Financial Integration		Neutral
Inclusion in major indices		Case for peg
Stock market capitalization		Case against peg
Financial development		Neutral
Economic Diversification		Case against peg
Terms of trade volatility		Strong case against peg
Commodity dependence		Case against peg
Macroeconomic Substitution		Neutral
Capital versus trade flows		Strong case against peg
Monetary volatility		Strong case for peg
Credibility		Neutral
Inflation history		Neutral
Fear-of-floating type effect		Case for peg
Exchange rate history		Strong case for peg
Deposits dollarization		Strong case for peg
Debt maturity pass through		Neutral

Conclusion:

Some of the strongest cases for a peg include the monetary volatility, balance sheet effects, and the high coefficient of variation between Lebanese growth and growth in the Dollar currency area (Figure 6).

On the other hand, factors that point towards a no-peg policy include capital mobility measured here using capital versus trade flows.

Finally, it is safe to say that the peg to the U.S. Dollar is a suitable exchange rate system for Lebanon even though some factors such as trade concentration, point in the direction of a peg that includes the Euro as well.

Figure 6. Sources: "The Peg or Not to Peg: A Template for Assessing the Dollar," IMF Working Paper, 2006
IMF, International Financial Statistics
Image of Lebanese currency from www.bankoflebanon.gov.lb

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