STANDARD & POOR'S

Sovereign Ratings

Lebanon (Republic of)

Primary Credit Analyst:
Ben Faulks
London
(44) 20-7176-7108
ben_faulks@
standardandpoors.com

Secondary Credit Analyst:
Farouk Soussa
PhD.
London
(44) 20-7176-7104
farouk_soussa@
standardandpoors.com

Additional Contact: Sovereign Ratings
SovereignLondon@
standardandpoors.com

RatingsDirect Publication Date
Jan. 3, 2006

Default history

None

Population

3.91 million

Per capita gdp

$5,799

Current government

President Emile Lahoud is head of state. The president, together with Prime Minister Fouad Siniora, and parliamentary speaker Nabih Berri, compose Lebanon's triumvirate of leaders.

Election schedule

Presidential

Last..........November 1998

Next........November 2007

Parliamentary

Last......May 2005

Next......May 2009

Major Rating Factors

Strengths:

- Sizable and resilient resident and nonresident deposits in Lebanon's financial sector enabling Lebanese banks to meet the government's financing needs
- A comparatively developed economy well placed to benefit from the unprecedented liquidity being generated by Gulf Arab countries

Weaknesses:

- Worsening political and geopolitical risks that could ultimately threaten stability
- Extremely high, and growing, public sector debt burden that severely constrains fiscal flexibility
- Weak prospects for meaningful economic reform in the near term

Rationale

Lebanon's political situation deteriorated markedly in 2006. Reconstruction of the physical infrastructure and housing stock destroyed during the month-long mid-year conflict between Hizbollah and Israel will absorb government energies into the medium term. However, potentially the more deleterious legacy of the war is the emergence of Hizbollah as a more assertive force in Lebanese politics. The demand of a Hizbollah-led coalition for greater representation in the cabinet has resulted in a political impasse for which there is no easy resolution. The dispute threatens to complicate policymaking and could, ultimately, result in civil unrest.

Recent political developments have raised pressure on Lebanon's public finances, which already record ratios among the poorest of any rated sovereign. Lebanon is expected to register a primary fiscal deficit in 2006 for the first time in years. Despite a substantial inflow of grants from supportive governments to fund infrastructure reconstruction the central government debt stock is estimated to have risen to 185% of GDP at year-end 2006, from 174% at year-end 2005. Political uncertainties could also result in the postponement of a broad international donor conference, scheduled for January 2007. Despite these difficulties, however, Lebanon is expected to avoid a payment default. Lebanon's financial sector—with total assets amounting to 3.3x GDP—will continue to provide sufficient liquidity for the government to meet its near-term financing requirements. Lebanon is also likely to secure official funds, particularly from Gulf Arab governments.

We assume a moderately robust upturn in economic growth in 2007 on the back of a reconstruction drive. Nevertheless, the prospects for bold policy initiatives such as state asset sales are poor, given post-war privations and political tensions. Consequently, Standard & Poor's Ratings Services does not envisage a near-term reduction in the debt stock. Public finances will therefore remain fragile, with interest payments accounting for more than one-half of central government revenues into the medium term.

Moreover, there are considerable downside risks. If Lebanon faces a prolonged period of government stasis, or worse, a slide into instability, the confidence-sensitive service sector would be harmed, damaging economic growth and financial sector depositor sentiment. This would increase the likelihood of default.

Outlook

The negative outlook reflects the risks posed by the current political impasse. There are three main triggers for a downgrade: a descent of the domestic political deadlock into violence that causes an outflow of deposits from the banking sector; prolonged gridlock that does not deteriorate into open strife but undermines confidence and economic growth and indefinitely delays reforms that are necessary to set public finances on a sustainable path; and—in the absence of a resolution of the political impasse—the failure of the international community to provide sufficient funds to ensure fiscal and balance of payments stability. Conversely, a resolution of the domestic political standoff could lead to a revision of the outlook to stable.

Table 1

Republic of Lebanon Selected Indicators

	2008f	2007f	2006e	2005	2004	2003	'B' Median 2006
GDP per capita ($)	6,546	6,218	5,782	5,728	5,626	5,299	1,207
Real GDP (% change)	3.5	5.5	(4.0)	1.0	6.0	4.9	5.4
Real GDP per capita (% change)	2.2	3.9	(5.2)	(0.6)	4.6	(2.9)	3.3
General government balance (% of GDP)	(13.3)	(13.8)	(14.4)	(7.6)	(8.6)	(12.8)	(2.8)
General government debt (% of GDP)	181.1	177.5	178.1	166.7	160.9	158.2	48.1
Net general government debt (% of GDP)	166.5	161.9	161.0	150.0	147.4	146.0	41.0
General government interest expenditures (% of revenues)	55.6	54.7	54.8	41.3	46.3	63.0	8.3
Domestic credit to private sector and NFPEs* (% of GDP)	72.7	73.8	76.7	75.7	77.3	79.5	26.3
Consumer price index (average; % change)	3.0	3.5	6.5	2.4	1.5	2.5	6.5
Gross external financing needs (% of CARs and usable reserves)	96.2	94.3	95.2	101.4	95.1	84.9	109.9
Current account balance (% of GDP)	(14.6)	(12.8)	(14.1)	(12.6)	(18.6)	(15.2)	(5.9)
Narrow net external debt¶ (% of CARs)	(23.2)	(32.4)	(37.5)	(49.1)	(45.2)	(54.2)	56.1

*Standard & Poor's estimates that, in a reasonable worst-case scenario, the government's contingent liability from a banking crisis could amount to 25%-40% of bank credit; see table 5 in "Banking Industry Country Risk: These Are The Good Old Days," published on June 6, 2006, on RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis. ¶Narrow net external debt is defined as total external debt minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. NFPE—Nonfinancial public enterprise. CARs—Current account receipts. f—Forecast. e—Estimate.

Comparative Analysis

- Lebanon's political risks exceed those faced by most of its peers.
- Fiscal flexibility, already weak, has worsened, in contrast to the trend evident among most peers.
- Per capita incomes, banking sector resilience, and economic development indicators are better than in Lebanon's peers.

Although many of its peers face substantial political and fiscal constraints, the dramatic events of the past year mean that Lebanon now faces greater challenges than most on both fronts. However, unlike Lebanon, nearly all of its peers have a recent history of default. Lebanon's external finances are also more resilient than its peers and it is generally more advanced in terms of economic development.

In political and fiscal terms, Lebanon's peers include the Republics of Bolivia (foreign currency B-/Negative/C; all references to ratings hereafter are to foreign currency sovereign credit ratings) and Ecuador (CCC+/Stable/C). The Bolivarian Republic of Venezuela (BB-/Positive/B) also offers a useful comparison. The Republics of Turkey (BB-/Stable/B) and Suriname (B/Positive/B) are valuable comparators on fiscal grounds. In terms of economic development, Lebanon's closest peers are similar low-income countries such as Turkey and the Oriental Republic of Uruguay (B+/Stable/B).

Political risks grow

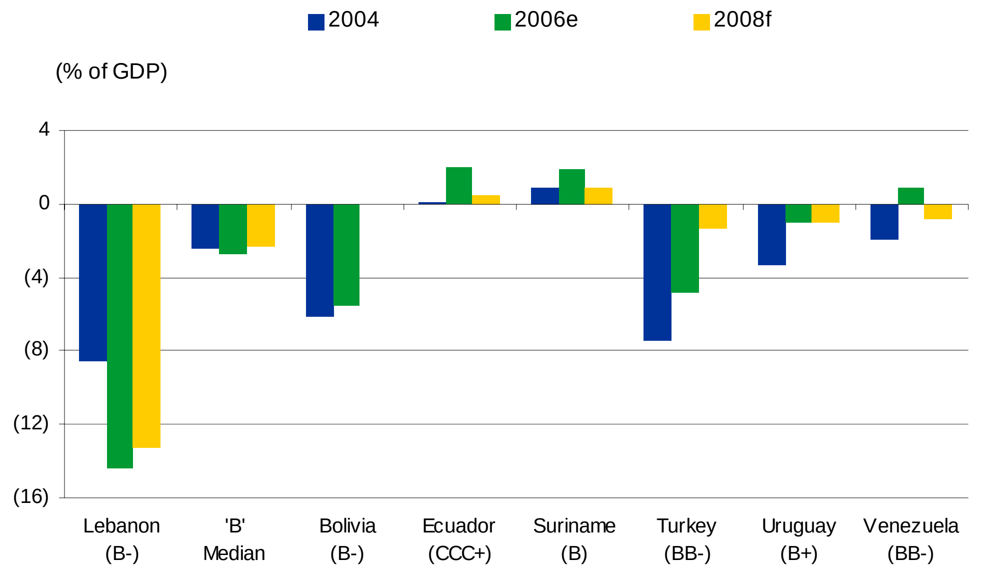
All these sovereigns face, to varying degrees, a political environment that constrains economic decision-making and weighs negatively on their ratings. Lebanon's political institutions are weak, and policymaking has long been undermined by sectarian rivalry. In a similar way, the ethnic divides in Ecuador, the Republic of Peru (BB+/Stable/B), and Venezuela heighten the risk of disruption in the implementation of economic policy. Lebanon's political landscape is, however, changing more rapidly than those of its peers. The optimism that followed the withdrawal of long-time occupying power Syria in early 2005, and the installation of a pro-reform cabinet that seemed prepared to embark on the kind of structural and fiscal reforms necessary to put exceptionally weak public finances on a track toward long-term sustainability, has dissipated. The conflict between Hizbollah and Israel and other deepening regional crises have combined to exacerbate uncertainties over Lebanon's domestic political outlook. At the very least, this clouds the outlook for economic reform; at worst, it could point to unrest.

Unlike Turkey, Lebanon lacks the policy anchor provided by an IMF program. External conditionality could prove a valuable anchor for policymaking, and strengthen the position of the reformist government vis-à-vis domestic opponents. Hopes that an international donor conference planned for January 2007 will provide such a framework have diminished, however. The conference may be delayed, and external support is unlikely to impose meaningful conditions in the current political climate.

Fiscal flexibility is poor and worsening

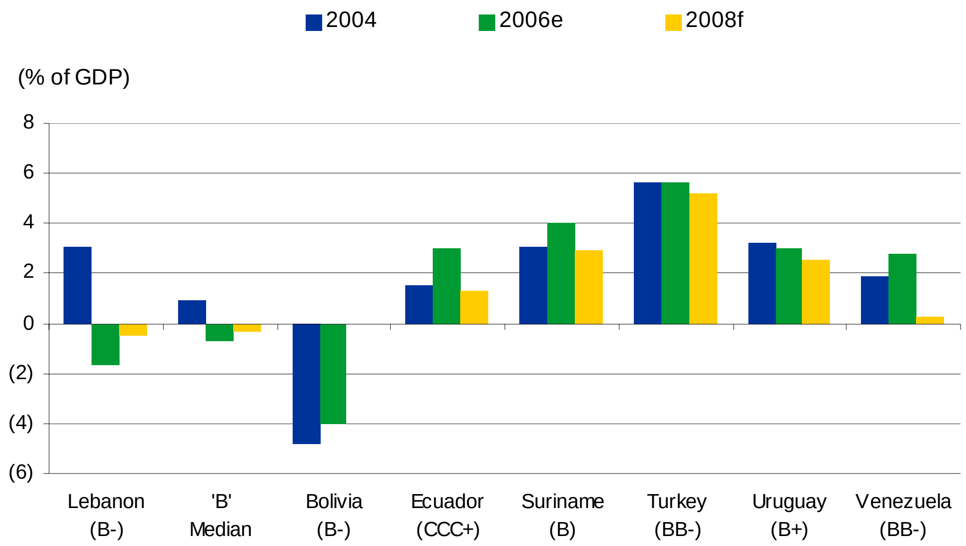
Weak government finances are typical among 'B' rated sovereigns. However, whereas the fiscal performance of many of Lebanon's peers is improving, frequently driven by sustained high oil prices, Lebanon's situation has worsened. Lebanon posts among the highest fiscal deficits and debt burdens of all rated sovereigns including its peer group (see chart 1). The conflict between Hizbollah and Israel will result in Lebanon registering a primary deficit for the first time in years (see chart 2). Although foreign grants are expected to meet the direct cost of infrastructure and housing reconstruction, the debt burden is forecast to continue to rise. The stock of general government debt, estimated at 178% of GDP at year-end 2006, is more than 3.5x that of the 'B' median, and is second only to Japan (AA-/Positive/A-1+) among all rated sovereigns (see chart 3). General government interest payments have risen to an estimated 54% of government revenues, which is by far the highest among peers (see chart 4). The interest burdens faced by Turkey, Venezuela, and Ecuador, the next largest, are in contrast all on a declining trend.

Lebanon Peer Group Comparison
General Government Balance



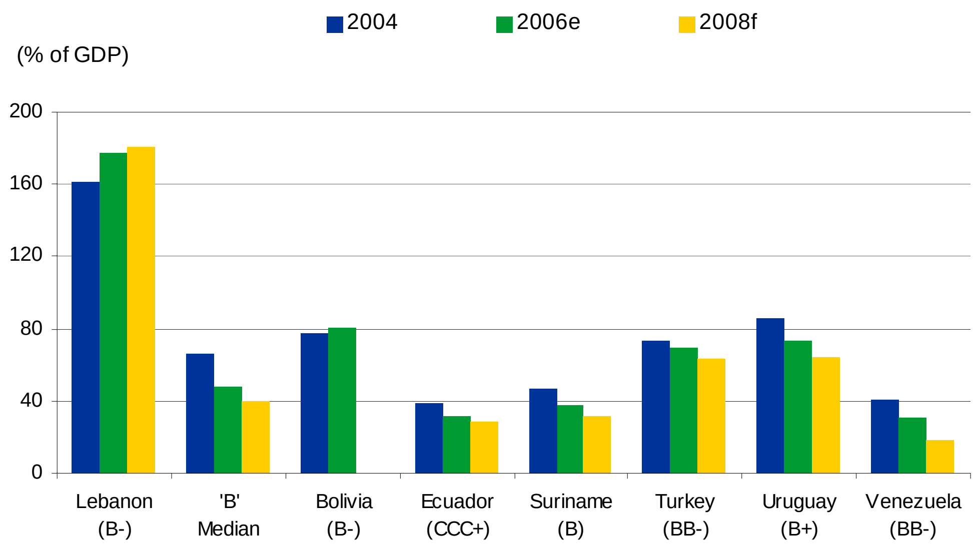
Note: data for Bolivia for 2008 not available. f--Forecast. e--Estimate.

Lebanon Peer Group Comparison
Central Government Primary Balance



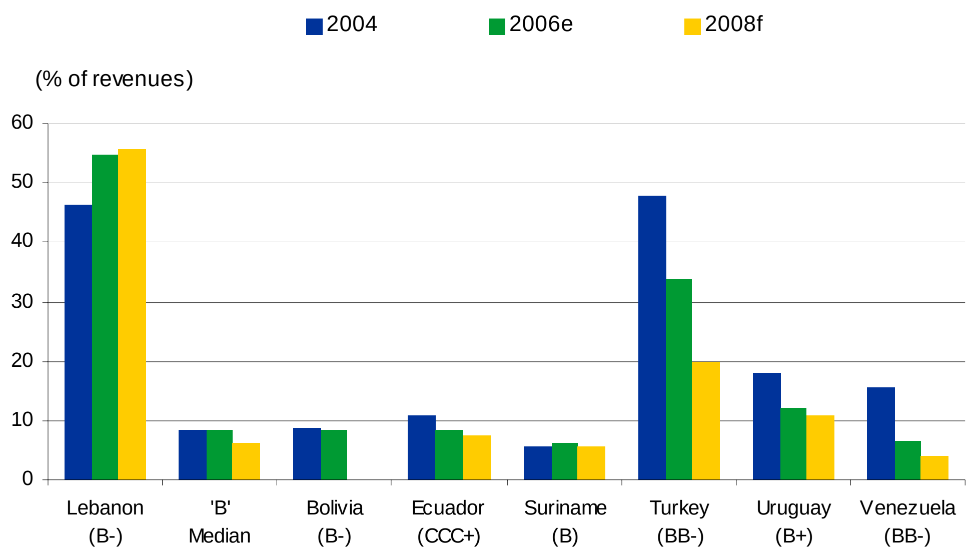
Note: data for Bolivia for 2008 not available. f--Forecast. e--Estimate.

Lebanon Peer Group Comparison
General Government Debt



Note: data for Bolivia for 2008 not available. f--Forecast. e--Estimate.

Lebanon Peer Group Comparison
General Government Interest Payments



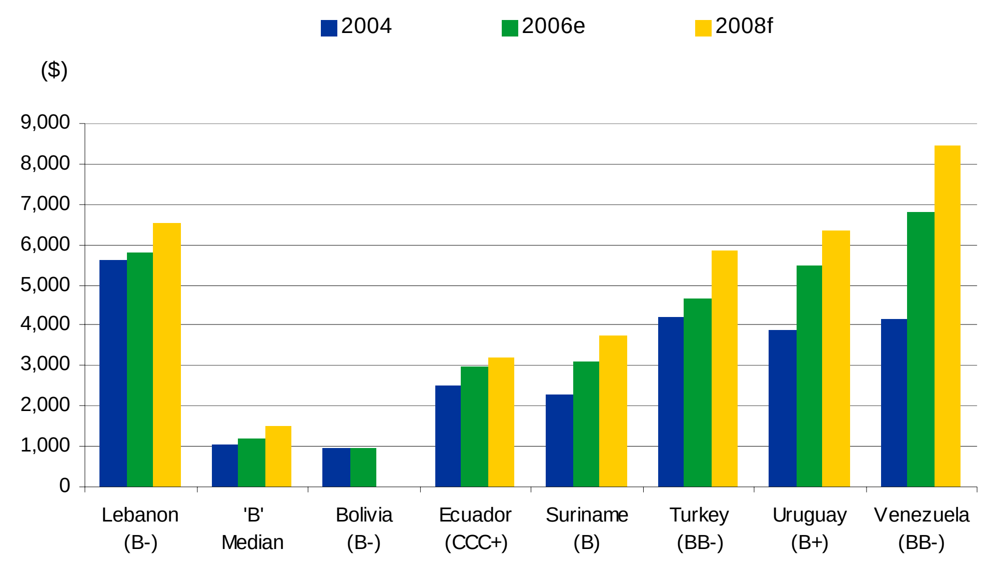
Note: data for Bolivia for 2008 not available. f--Forecast. e--Estimate.

Unlike peers such as Ecuador and Suriname—which largely rely on access to official sources to meet their financing requirements—sizable resident and nonresident deposits in Lebanon's financial sector have enabled Lebanese banks to meet the government's financing needs. Unlike Turkey, nonresident holdings of Lebanese government debt remain very low, which allows greater resilience to political and economic setbacks. Lebanon also stands out from peers in that its banking sector and its money supply in relation to GDP are much larger and have so far sustained Lebanon's large debt burden. Similarly to Ecuador, Bolivia, and Uruguay, however, the Lebanese economy is heavily dollarized. In this regard, 71% of resident deposits are U.S. dollar denominated, which makes banks, the public sector, and the exchange rate, more vulnerable to depositors' confidence than is the case among peers. Lebanon's banking system is stronger and more open than that of its peers, however, with total assets equal to an estimated 3.3x GDP at year-end 2006. In a reasonable worst-case scenario, Standard & Poor's estimates gross problematic assets at 25% to 40% of domestic credit to the private sector. This is the same range as in Uruguay and Turkey, but a lower range than in Bolivia (35%-50%) and Ecuador (50%-75%). Furthermore, unlike Uruguay and Turkey, the banking sector is a net external creditor.

Indicators of economic development surpass most peers

Lebanon has a small and open economy, and its wealth measured in GDP per capita terms, forecast at $5,790 in 2006, far exceeds the 'B' median of $1,210 (see chart 5). Moreover, the true wealth of the Lebanese population as measured by GNP figures is likely to be higher, given the extent of remittances sent by Lebanese workers in the Gulf countries and from the relatively wealthy Lebanese diaspora elsewhere. As in most peers, however, income disparities are wide, and have the potential to threaten social stability. Lebanon ranks 78 out of 177 in the 2006 U.N. Human Development Index, surpassing its peers in many more highly rated sovereigns including Jordan, Suriname, Turkey, and Pakistan, although it ranks behind Uruguay and Venezuela.

Lebanon Peer Group Comparison
GDP Per Capita

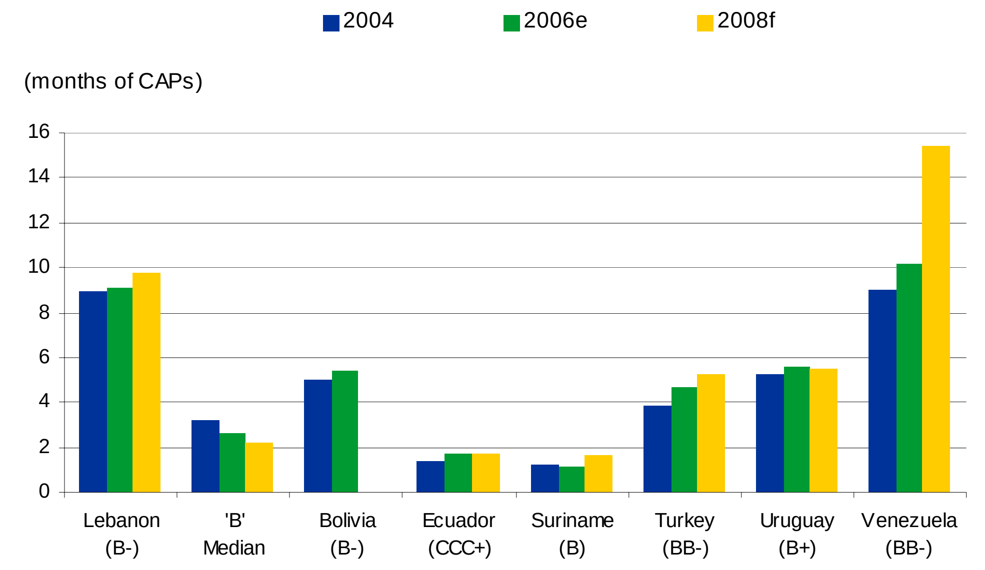


Note: data for Bolivia for 2008 not available. f--Forecast. e--Estimate.

External flexibility compares favorably to peers

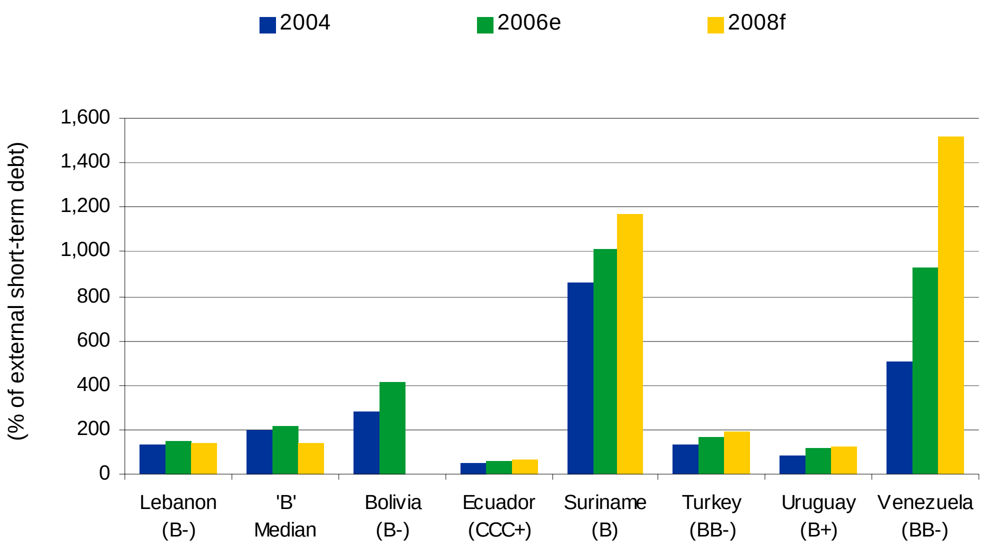
Lebanon's current account deficit is the highest in its peer category, projected at 14% of GDP in 2006. By contrast with most peers, however, a wealthy pool of available funding, largely nonresident deposits in Lebanese banks, has traditionally provided full coverage of the external gap. In addition, capital inflows have proved resilient overall to political woes, as nonresident investors—many of Lebanese origin—are familiar with the risks present in the country. Lebanon's money supply (M3) of 2.4x the size of its economy, the strength of its banking sector, and usable reserves equivalent to more than nine months of current account payments are also factors that compare favorably with peers and diminish the risk of a balance of payment crisis (see chart 6). Reserve coverage of short-term external debt (including foreign currency deposits) at 150%, however, is weaker than that of most peers (see chart 7). That said, this is partially balanced by the resilience demonstrated by depositors and the financial system.

Lebanon Peer Group Comparison
Usable Reserves



Note: data for Bolivia for 2008 not available. CAPs--Current account payments. f--Forecast. e--Estimate.

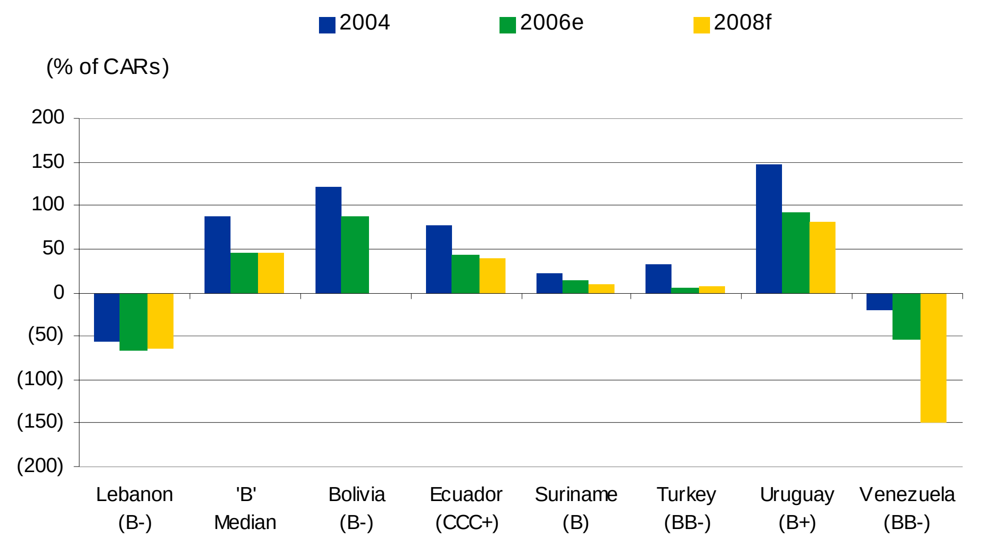
Lebanon Peer Group Comparison
Usable Reserves



Note: data for Bolivia for 2008 not available. f--Forecast. e--Estimate.

The government's net external position also compares favorably among peers, despite the Lebanese government's foreign currency denominated debt estimated at 97% of GDP at year-end 2006. Lebanon's government holds a net external asset position of an estimated 66% of current account receipts (CARs) in 2006, as more than 90% of its debt, including both local and foreign currency, is held by resident banks and investors (see chart 8).

Lebanon Peer Group Comparison
Net External General Government Debt



Note: data for Bolivia for 2008 not available. CARs--Current account receipts. f--Forecast. e--Estimate.

Political Environment:Tensions Mount

- Reconstruction of the infrastructure and housing stock damage caused during the month-long war between Hizbollah and Israel will occupy government energies into the medium term.
- The main legacy of the war is a more assertive Hizbollah determined to augment its executive powers.
- Political uncertainties threaten to delay an international donor conference planned for January 2007.

Lebanon's divisive political system looks more precarious than at any stage since it was established at the end of the 15-year civil war in 1990. In a formula approved under the Taif agreements of 1989, the different religious denominations practice a power-sharing arrangement that stipulates a Maronite Christian president, a Sunni prime minister, and a Shi'ite parliamentary speaker. The cabinet, too, maintains a fairly even representation of the main communities.

Although expedient, this system has institutionalized confessional divisions and has taken no account of demographic changes. Sectarian rivalries have undermined the implementation of fiscal and structural reforms. The cabinet's effectiveness has, in the past, been further compromised by Syrian control, which weakened the independence and credibility of Lebanon's sovereign institutions. Consequently the withdrawal of Syrian forces from Lebanon in April 2005, after 25 years of occupation, raised hopes of more determined and effective governance. The installation of a cabinet headed by Fouad Siniora, a close ally of assassinated former prime minister and leading advocate of economic reform, Rafik Hariri, underpinned the optimism. Instead, however, the dramatic events of 2006 raise substantial concerns over the prospects for economic policymaking and will test the durability of the existing political contract.

The July-August 2006 conflict between the Lebanese Shi'ite guerilla group Hizbollah and Israel displaced almost a million people, severely damaged Lebanon's infrastructure and weakened its productive capacity. Resettlement and reconstruction pose a funding and organizational challenge that will absorb government energies into the medium term.

Potentially the most far-reaching legacy of the war, however, is the emergence of Hizbollah as a more muscular force within Lebanese politics. Emboldened by its enhanced standing within certain sections of

Lebanese society and the almost unanimous praise it won at a popular level in neighboring, predominantly Sunni, countries for resisting Israel, Hizbollah appears determined to strengthen its executive powers. In partnership with Amal, the other key Shia organization, and the Free Patriotic Movement of Michel Aoun, a hard-line Maronite Christian leader, Hizbollah is pressing for a national unity government that would give the coalition sufficient cabinet seats to veto proposed policies—a demand the Siniora government has refused. To illustrate the seriousness with which Hizbollah is pursuing this goal, in mid-November six ministers aligned with the coalition withdrew from the cabinet; in early December Hizbollah launched an indefinite mass sit-in aimed explicitly at bringing down the Siniora government.

Even if the Siniora government survives—the loss of only three more ministers would bring the government down—the near- to medium-term prospects for bold structural and fiscal reform are poor. The cabinet is aware that socially painful measures risk heightening sectarian tensions and are inappropriate given the persistence of heavy deprivations resulting from the war. The assassination in November of Pierre Gemayel, an anti-Syrian minister from an establishment Christian family, will further deter contentious initiatives. If the government were to acquiesce to Hizbollah's demands, the group would be unlikely to advocate a repudiation of Lebanon's debt obligations. Nevertheless, the decision-making process would be greatly complicated, with no grouping enjoying supremacy. The political impasse threatens to complicate the selection of a president in November 2007, further undermining the functioning of government; Aoun appears the most popular contender within the Christian community and seems intent on securing the position, but lacks the necessary support within parliament, responsible for selecting the president.

The impasse necessarily raises questions over the outlook for Lebanese political stability. Memories of the devastating civil war temper excesses. No faction wants to be seen as undermining national unity, and Hizbollah consistently emphasizes its nationalist credentials. The Siniora government retains the support of the Sunni and Druze communities and most Christians and holds a solid parliamentary majority. Hizbollah is aware that it cannot form a government on its own.

Yet, there are a number of inter-connected issues that could cause a slide into instability. The poor Shia have the weakest representation in government but are the largest and fastest-growing community. Hizbollah will have strong support in its efforts to address those grievances. Crucially and most pressingly, however, the interests of Syria, a leading backer of Hizbollah, are at stake. Anti-Syrian Lebanese argue that Syria benefits from the enhancement of Hizbollah's powers so that it can veto the Siniora government's support for the establishment of a U.N. tribunal to try suspects in the Hariri assassination—initial U.N. investigations have implicated Syrian officials. Instability would also give Damascus a pretext to reassert its influence in Lebanon, opponents contend. Iran, which founded Hizbollah, also sees itself as benefiting from the group's empowerment, primarily to act as a counter-weight to Israel. As long as tensions persist between Iran and Israel over Iran's nuclear program, the risk of renewed hostilities between Hizbollah and Israel will remain. Hizbollah will steadily replenish its military capacity; the newly reinforced U.N. peacekeeping force in southern Lebanon has no mandate to disarm the group.

Political uncertainties raise doubts over the prospects for a donor conference scheduled for January 2007. In Lebanon's favor, although the gathering may be postponed, Western countries—primarily the U.S. and France—and Gulf Arab states, led by Saudi Arabia, will ultimately be concerned to shore up the Siniora government and to prevent the unraveling of Lebanon's precarious finances. Nevertheless, financial support may well remain limited in scope until the political outlook becomes clearer. Moreover, immediate funding seems unlikely to be made conditional on structural reform. The net impact would be to provide short-term relief but to do little to expedite economic reform of the magnitude necessary to set public finances on a path toward long-term sustainability.

Economic Prospects:Service Sector Volatility

- The confidence-sensitive service sector that dominates the economy has suffered as a result of recent political turbulence.
- The government's large fiscal imbalances continue to crowd out private investment.
- GDP growth is forecast to recover to more than 5% in 2007 from a contraction in 2006.

Table 2

Republic of Lebanon Economic And Financial Indicators

	2008f	2007f	2006e	2005	2004	2003
Nominal GDP (bil. LB£)	39,670	37,212	34,079	33,332	32,228	29,954
Nominal GDP (bil. $)	26.3	24.7	22.6	22.1	21.4	19.9
GDP per capita ($000s)	6.5	6.2	5.8	5.7	5.6	5.3
Real GDP (% change)	3.5	5.5	(4.0)	1.0	6.0	4.9
Real GDP per capita (% change)	2.2	3.9	(5.2)	(0.6)	4.6	(2.9)
Real domestic demand (% change)	2.0	3.6	(6.2)	1.6	5.4	3.8
Real investment (% change)	8.0	8.0	5.0	2.0	8.0	5.0
Gross domestic investment (% of GDP)	22.1	21.2	20.7	18.9	18.7	18.4
Gross domestic savings (% of GDP)	7.6	8.4	6.6	6.3	0.2	3.2
Real exports (% change)	12.0	11.5	16.4	3.0	10.0	20.0
Consumer price index (% change)	3.0	3.5	6.5	2.4	1.5	2.5
Domestic credit to private sector and NFPEs (% change)	5.0	5.0	3.6	1.3	4.7	3.9
Domestic credit to private sector and NFPEs (% of GDP)	72.7	73.8	76.7	75.7	77.3	79.5

LB£—Lebanese pound. NFPE—Nonfinancial public enterprise. f—Forecast. e—Estimate.

Economic structure

An extreme shortage of statistics hampers analysis of Lebanon's economic structure and performance. With no significant industrial base, sparse natural resources, and a small agricultural sector, economic activity is biased toward the service sector, which is estimated at about 60% of economic activity. This is followed by industry, which represents about 14%, construction at 9%, and agriculture, at 6% of GDP. Net income from abroad is substantial, reflecting transfers from Lebanese workers in the Gulf countries and from the 12 million-13 million Lebanese in the diaspora.

Economic activity is dominated by financial services, and increasingly tourism, which alone accounts for 10%-15% of GDP. The banking sector's impressive asset base of more than 3x GDP is one of the highest among rated sovereigns, signaling the wealth of many Lebanese, and the role of the large expatriate population in the domestic economy.

Tourism has grown strongly in recent years, fuelled by demand from visitors from Gulf countries, in turn spurring the construction sector. The sector suffered a downturn following the assassination of Hariri in early 2005, however, and took an even bigger knock in 2006 as the conflict between Israel and Hizbollah devastated demand in the peak summer months. The damage was compounded by the ensuing tensions between Hizbollah and the Siniora government, and recovery will hinge on the abatement of security concerns. Provided political uncertainties ease, the medium-term outlook for the sector is robust, given the attractions of Lebanon as a tourist destination and probable continued strong liquidity generated by Gulf Arab states, which will drive both demand and investment.

Despite a liberal and open business environment, high operating costs—including social security contributions, energy prices, and tariffs on raw materials—together with cumbersome tax and commercial laws and procedures, have constrained the development of the domestic private sector, even before factoring in political setbacks. Investment by the domestic private sector is also constrained by limited access to long-term financing, as interest rates remain high and large fiscal imbalances continue to monopolize banks' balance sheets.

Economic growth

Growth rose strongly in the first half of 2006, but contracted sharply as the conflict damaged the confidence-sensitive service sector—primarily tourism—and hit agriculture. An Israeli blockade interrupted commerce and cut off capital goods to industries already suffering from power shortages. Confidence and economic activity, particularly in Beirut, were further damaged by the political dispute that gripped the country later in the year, consigning full-year growth to a contraction estimated at around 4% of GDP.

Provided political tensions are kept in check, growth is expected to rebound moderately in 2007 as the reconstruction drive gathers momentum. The cost of repairing physical damage to infrastructure alone is estimated at between $2 billion and $4 billion (8.8%-17.7% of GDP)—without including the cost of replenishing the housing stock in the predominantly Shia areas damaged by the Israeli airforce. Funding is unlikely to prove a major barrier, as foreign grants will meet most of the costs. Yet, a number of sectors may suffer a longer-term legacy: tourism sentiment may take time to recover, and slow progress clearing unexploded Israeli ordnance in the south will constrain the recovery in agriculture.

Assuming the impasse that is currently preventing effective governance and undermining investment and consumer confidence is overcome, and the government reasserts its commitment to and focus on tackling structural and fiscal imbalances, long term growth of around 3.5% per year is achievable.

Fiscal Flexibility:Conflict Takes Its Toll On Budget

- The conflict between Hizbollah and Israel caused a sharp rise in the fiscal deficit in 2006.
- Political uncertainty clouds the prospects for fiscal and structural reform crucial for an overhaul of public finances.
- The probability of support from Gulf Arab countries and Western states and strong liquidity in Lebanon's financial system mitigate the risk of default.

Table 3

Republic of Lebanon Fiscal Indicators						
(% of GDP)	***2008f***	***2007f***	***2006e***	***2005***	***2004***	***2003***
General government debt	181.1	177.5	178.1	166.7	160.9	158.2
Of which central government debt	187.3	184.0	185.2	174.1	167.7	166.7
General government net debt	166.5	161.9	161.0	150.0	147.4	146.0
Of which central government net debt	172.7	168.4	168.2	157.3	154.2	154.5
General government revenues	23.6	23.6	23.6	25.7	26.9	25.8
Of which central government	20.4	20.4	20.4	22.2	23.3	22.2
General government expenditures	36.9	37.3	38.0	33.3	35.5	38.6
Of which central government	34.0	34.4	35.0	30.6	32.7	35.4
General government balance	(13.3)	(13.8)	(14.4)	(7.6)	(8.6)	(12.8)
Of which central government	(13.6)	(14.0)	(14.6)	(8.4)	(9.4)	(13.2)
General government primary balance	(0.2)	(0.9)	(1.5)	3.0	3.9	3.5
Central government primary balance	(0.5)	(1.1)	(1.7)	2.2	3.1	3.1
General government balance (% of revenues)	(56.4)	(58.4)	(61.1)	(29.7)	(31.8)	(49.6)
General government interest payments (% of revenues)	55.6	54.7	54.8	41.3	46.3	63.0
Central government interest payments (% of revenues)	64.3	63.2	63.3	47.7	53.5	73.2

f—Forecast. e—Estimate.

Expenditure, revenue, and balance performance

Lebanon is estimated to have registered a primary fiscal deficit in 2006 for the first time in years. The war raised spending pressures and damaged receipts, overshadowing a strong improvement in the fiscal outturn for the first half of the year. Revenue is expected to fall by about 6%, reversing a 15% year-on-year gain over the first six months of the year, as the blockade hit customs receipts, while VAT revenue contracted along with consumption. Non-debt spending fell in January-June, but this trend will have reversed sharply in the second half as the government allocated funds for: emergency relief; reconstruction; support to state electricity monopoly Electricité du Liban (EDL; which suffered infrastructural damage); and for additional military spending (Lebanon is required to send 15,000 troops to the south under U.N. Security Council Resolution 1701). The government also faces a rise in average interest rates as local and foreign currency zero-interest debt issued to local banks under the Paris II donor conference in 2003 has matured. This is estimated to have pushed the overall central government deficit up to 14% of GDP.

The direct cost of repairing the infrastructure and housing stock destroyed during the war should be met largely by an inflow of foreign grants. The fiscal outlook remains uncertain, however. It depends in part on the speed of economic recovery—itself a factor of political uncertainties that affect confidence—and progress on restoring Lebanon's productive assets. The prospects for initiatives that could have a substantial impact on the debt stock, such as sale of Lebanon's two GSM licenses, are weak. The other key variable is the extent of foreign support—whether via a Paris III conference or more informally—to improve Lebanon's debt profile. Although some financing is likely, the size of the funds is difficult to forecast. Assuming no foreign financing, Lebanon would face deficits averaging close to 14% of GDP in 2007-2008, as interest payments rise sharply on the back of the debt stock growth.

Government debt and interest burdens

The central government debt-to-GDP ratio is forecast to increase to 185% of GDP in 2006, from 174% a year earlier. Without major state asset sales, Standard & Poor's forecasts that the central government debt-to-GDP ratio would rise to 187% of GDP in 2008. The central government interest payments-to-revenues ratio declined from nearly 90% in 2000 following the Paris II conference, to 48% in 2005, but is estimated to have risen sharply in 2006 to 63%. Debt servicing therefore remains the most severe constraint on fiscal flexibility, underscoring the pressing need to reduce the debt stock. Rollover risks are likely to remain manageable in the short-term, as international funds are likely and as commercial banks (whose fortunes are tied to government solvency) remain supportive. It is estimated that domestic banks hold more than 90% of government market debt (total debt in local and foreign currency excluding that held by public entities, bilateral and multilateral loans, and loans related to Paris II).

Off-budget and contingent liabilities

The financial system represents the most significant contingent liability for the government. Standard & Poor's estimates that the potential gross problematic assets of the Lebanese financial system, in a reasonable worst-case scenario, are at most 40% of domestic credit to the private sector, equivalent to 31% of GDP in 2006.

Monetary Policy:Peg Stability Maintained

- The relatively robust central bank reserve position and history of successful defense of the peg has mitigated the impact of political turbulence on the deposit base.
- Inflationary pressures will rise in the near term but remain manageable.

Formally, the Banque du Liban's (BdL) primary objective is to maintain the Lebanese pound's long-standing peg to the U.S. dollar, which provides a nominal anchor for the economy. Although notionally independent, the BdL continues to provide financing for the government when necessary to stave off default and to maintain financial stability and has, in the past, incurred losses in doing so.

The domestic banking sector provides the bulk of both private sector and government financing. At the end of September 2006, the banking sector's direct exposure to the government and to the BdL stood at Lebanese pound (LB£) 30.4 trillion ($20.2 billion, or 27% of total banking assets). The interdependence of the banks with the government is underlined by their purchase of $3.6 billion in two-year government zero-coupon bonds in 2002, and their willingness to refinance the sovereign's 2005 and 2006 Eurobond maturities.

Depositors' confidence is critical to the banks' ability to finance the government. Following the outbreak of hostilities in early July, there was a drawdown in private sector deposits by end-August of 3.4%, driven by a decline in Lebanese pound deposits by 13%. Private sector deposits in foreign currency rose slightly, bringing the deposit dollarization rate to 72% in August from 68% in June. Private sector local currency deposits rose again in September and the dollarization rate fell to 71%.

The BdL's significantly improved reserve position allowed it both to meet all foreign exchange demands and to engender confidence in the financial system. Bolstered by a deposit of $1.5 billion from Saudi Arabia and Kuwait, BdL reserves rose to $13.8 billion at Sept. 30, 2006. Including gold, usable reserves rose to around $19 billion, equivalent to 37% of M3 money supply—comprising cash and deposits, including foreign currency deposits—and 79% of the local currency money supply. This is a comfortable position from which to defend the currency in the event that sentiment turns negative.

Inflation is expected to have risen sharply in 2006 to around 6.5%, driven by scarcities brought on by the war; the reconstruction drive may also bring inflationary pressures in 2007. Nevertheless, underlying inflation pressures remain moderate. Headline inflation is forecast to decline to 3.5% in 2007 and to 2.5% in 2009.

External Finances:Expatriate Funding Remains Crucial

- The current account deficit is expected to widen in 2006 as tourism receipts fall.
- Nonresident deposits and other recurrent capital inflows are vital to provide coverage of the large external gap.
- The public sector has net external assets of 66% of CARs, as foreign currency-denominated government debt is largely held by domestic investors.

Table 4

Republic of Lebanon External Indicators

(% of GDP)	*2008f*	*2007f*	*2006e*	*2005*	*2004*	*2003*
Current account balance	(14.6)	(12.8)	(14.1)	(12.6)	(18.6)	(15.2)
Trade balance	(30.4)	(30.6)	(31.8)	(31.0)	(33.2)	(26.3)
Net foreign direct investment	4.6	6.9	3.5	7.6	6.9	7.8
(% of CARs)						
Current account balance	(18.4)	(15.7)	(17.1)	(14.8)	(22.3)	(18.8)
Net external liabilities	85.6	70.0	58.7	41.3	40.0	34.5
Total external debt	148.6	139.5	140.7	108.8	118.8	108.2
General government external debt	35.2	34.6	35.5	31.7	32.0	33.7
Narrow net external debt*	(23.2)	(32.4)	(37.5)	(49.1)	(45.2)	(54.2)
Net public sector external debt	(65.5)	(64.9)	(66.4)	(56.1)	(56.1)	(67.3)
Net nonbank private sector external debt	(8.7)	(15.0)	(19.6)	(29.2)	(22.6)	(26.8)
Net banking sector external debt	0.9	(2.6)	(3.7)	(8.7)	(8.2)	(3.6)
Net investment payments	7.7	7.3	7.0	4.4	8.0	7.7
Net interest payments	3.3	2.9	2.7	1.2	1.7	22.9
Reserves/CAPs (months)	9.7	9.8	9.1	8.7	9.0	6.5
Gross external financing needs (% of CARs and usable reserves)	96.2	94.3	95.2	101.4	95.1	84.9

*Narrow net external debt is defined as total external debt minus liquid nonequity external assets, which include official foreign exchange reserves, other liquid public sector foreign assets, and financial institutions' deposits with and lending to nonresidents. A negative number indicates net external lending. CARs—Current account receipts. CAPs—Current account payments. f—Forecast. e—Estimate.

External liquidity

Meaningful analysis of Lebanon's balance of payments is constrained by a shortage of reliable statistics. Lebanon's export capacity is low, particularly compared with the country's import needs, as reflected by a trade deficit estimated at 32% of GDP in 2006. The huge trade deficit is typically partially offset by transfers and services surpluses. The current account deficit is expected to widen in 2006 to just above 14% of GDP, driven by a decline in tourism receipts. The negative impact of the mid-year conflict will be tempered, however, by an inflow of grants for reconstruction. The current account deficit is forecast to narrow slightly in 2007 as tourism gradually strengthens, before widening again in 2008 as grant inflows ease.

There is potential for considerable growth in direct and portfolio equity investment, driven by Gulf Arab countries that are likely to continue to generate large current account surpluses on the back of high oil prices. Much depends on political developments, however, and if concern mounts over the outlook for stability, inflows would decline accordingly. The extent of inflows will also depend on the achievement of a hitherto elusive consensus over privatization of major state assets.

Non-equity capital inflows will therefore remain vital. These are largely banking deposits of nonresident Lebanese and other Gulf investors. In the past, such flows have proven resilient to political risks, with the outflow of deposits relatively limited and short-lived following recent political crises. The principal reason for this is that main depositors are familiar with Lebanese risks. Risks are further diminished as the size of capital inflows is not very significant relative to the pool of wealth that originates them. Nevertheless, if reform that is crucial to the sustainability of Lebanon's public finances is continuously delayed, confidence would suffer. Furthermore, a breakdown of political order would probably have a severe impact on depositor confidence.

Narrow net external debt

In 2006, Lebanon registered a narrow net external asset position equivalent to an estimated 38% of CARs. Total public sector external debt is forecast at 35% of CARs at year-end 2006. In net terms, public sector assets are forecast at 66% of CARs in 2006. About one-half of the government debt is denominated in U.S. dollars, but nonresident holdings of Eurobonds are estimated to remain low, at about 10% of the total. Net external assets of the banking sector diminished to an estimated 4% of CARs in 2006 from about 9% in 2005. Although banks' open positions are limited by law to a maximum of 1% of equity, in practice, foreign currency-denominated lending—which accounts for more than 80% of total bank loans—indirectly exposes the sector to foreign exchange risk. Data on the nonbank external sector is sketchy, but the sector is a moderate external creditor. Estimates derived from Bank for International Settlements statistics point to net external nonbank private sector assets of 29% of CARs in 2005.