International
Credit Analysis

Republic of Lebanon

Ratings

Foreign Currency
Long-Term IDR* ..... B-
Short-Term IDR* ..... B
Outlook ..... Positive

Local Currency
Long-Term IDR* ..... B-
Outlook ..... Positive

Country Ceiling ..... B-

* IDR – Issuer Default Rating

Peer Group

B	Benin Mozambique PNG Suriname Uganda
B-	**Lebanon** Bolivia Cameroon Dominican Rep Ecuador Mali Moldova
CCC+	Gambia (The) Malawi

Ratings History

Date	LTFC	LTLC
Sep 2001	B-	B-
Feb 2001	B+	B+
Jun 1999	BB-	BB
Jun 1998	BB-	BB+
Feb 1997	BB	BBB-

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Summary

Political changes triggered by the assassination of former PM Rafik Hariri in February make it more likely than not that a reform programme will be approved and implemented, with financial support from donors. With the public debt burden broadly stable since 2002, helped by donor support after the Paris II conference and an important primary fiscal adjustment, and against the background of momentous political change and a supportive external environment, Lebanon has an opportunity to make a decisive impact on its economic prospects. (The forecasts for 2006-7 do not take any account of prospective privatisation receipts, donor assistance or debt management operations).

The withdrawal of Syrian troops and intelligence agents paved the way for elections in June which brought to power a reformist government under former Finance Minister Siniora. A comprehensive reform programme is being developed, in advance of a donor conference early next year. There seems broad consensus in favour of reform, reducing the risk of a repeat of the disappointed expectations that followed Paris II. Nevertheless, the new political situation presents its own risks and challenges and the extent and pace of reform remains to be seen.

The assassination of such a colossal figure as Hariri is widely regarded as the severest test Lebanon has faced since the civil war. In that context, the economy has weathered the storm reasonably well. Growth initially slumped but has since recovered. And although there was substantial dollarisation of deposits, deposit flight was manageable and short-lived. After a brief period of central bank support, bank appetite for Lebanese debt resumed and foreign appetite has increased recently. Official reserves have regained their end-2004 level and bank deposits are growing again.

Credit Outlook

The Positive Outlook assumes fiscal and structural reforms are approved, begin to be implemented and receive donor support. Strong implementation would bring a rating upgrade. Failure to implement would bring negative rating action.

Strengths

- Strong support from banks, the Lebanese diaspora and donors
- 60% of public FC debt domestically held, resulting in public and overall net external creditor positions
- Unblemished external and domestic debt service record
- Relatively high per capita income

Weaknesses

- Heavy public debt burden
- Large budget and current account deficits
- Reform implementation is politically challenging
- Currency peg with high dollarisation, non-resident deposits and banks’ sovereign exposure is a major systemic risk

29 December 2005

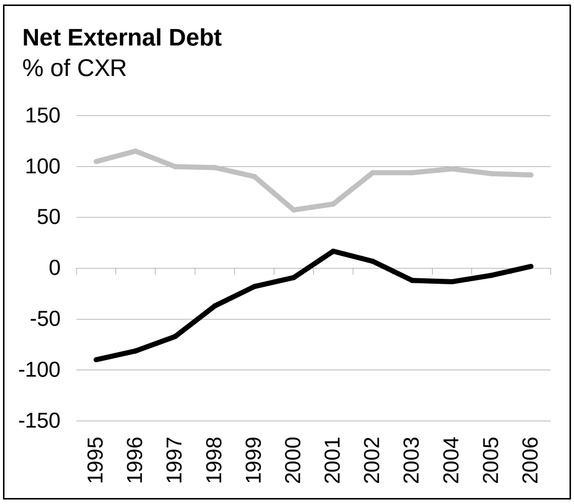
Key Indicators for Lebanon

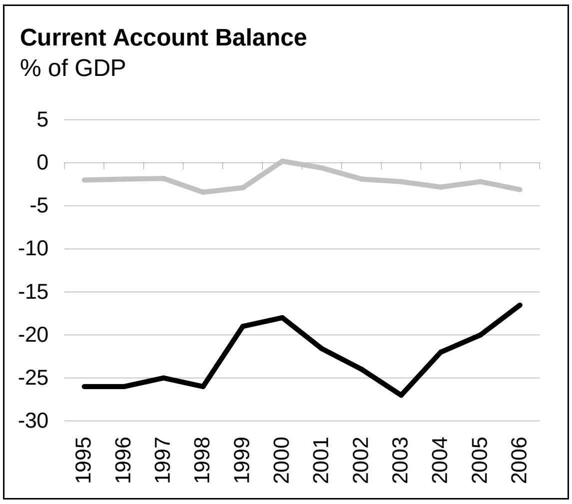
Population (2004): 3.5m **Population Growth Rate (2000-2004):** 1.0% p.a.
GDP (2004): USD21.9bn **GDP per Head at Market Exchange Rates (2004):** USD6,176
GNI Per Head at Purchasing Power Parity (2004): USD5,380 (= 14% of USA level)
Modern Sovereign Rescheduling History: None

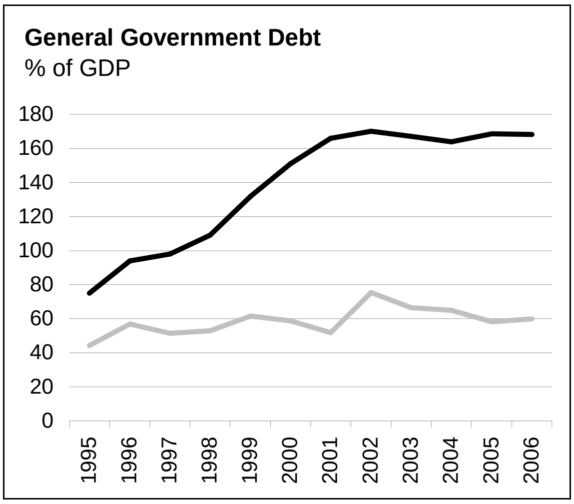
	2001	2002	2003	2004	2005f	2006f	2007f
Domestic Economy and Finance							
Real GDP Growth (%)	4.4	2.6	5.0	6.0	1.0	3.0	4.0
Unemployment (% of Labour Force)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Consumer Prices (Annual Average % Change)	-0.4	1.8	1.3	3.0	2.0	2.0	2.5
Gross Domestic Savings (% of GDP)	-2.9	-1.9	1.2	-4.0	-4.8	-3.9	-3.8
Gross Domestic Investment (% of GDP)	23.0	18.4	19.1	23.9	24.3	23.2	23.8
Short-Term Interest Rate (%)[1]	11.2	10.9	6.2	5.3	5.2	5.5	5.6
Broad Money (% Change Dec to Dec)	7.5	8.1	13.0	10.1	3.3	5.6	7.3
LBP per USD (Annual Average)	1507.5	1507.5	1507.5	1507.5	1507.8	1508.0	1508.0
REER (CPI, 2000=100)	102.1	99.8	88.6	82.4	82.6	82.6	82.6
REER: % Change (+ = Appreciation)	2.1	-2.3	-11.2	-6.9	0.2	0.0	0.0
Public Finances							
General Government Balance (% of GDP)	-17.6	-16.1	-13.7	-9.8	-8.0	-7.9	-7.1
General Government Debt (% of GDP)	165.9	169.9	166.9	164.0	168.5	168.3	165.0
General Government Debt Maturities (% of GDP)[2]	69.6	64.0	56.3	62.0	38.3	42.9	36.8
General Government Debt/Revenue (%)	918.9	811.2	755.8	719.4	780.9	765.8	741.0
Interest Payments/Revenue (%)	92.8	80.8	73.2	53.5	43.2	46.3	45.7
Balance of Payments							
Current Account Balance (USDm)	-3704	-4385	-5463	-4797	-4579	-3838	-4336
Current Account Balance (% of GDP)	-21.7	-23.8	-27.3	-21.9	-20.3	-16.2	-17.2
Current Account Balance plus Net FDI (USDm)	-2186	-3049	-3194	-3750	-3079	-1838	-2336
Current Account Balance plus Net FDI (% of GDP)	-12.8	-16.5	-16.0	-17.2	-13.7	-7.8	-9.3
Gross Financing Requirement (% of Reserves)[3]	72.4	110.9	119.8	57.7	58.7	53.3	55.9
Current External Receipts CXR (USDm)	8827	8696	16680	18294	18931	21053	22596
Current External Receipts CXR (Annual % Change)	0.3	-1.5	91.8	9.7	3.5	11.2	7.3
Current External Payments CXP (USDm)	12531	13080	22143	23092	23511	24891	26932
Current External Payments CXP (Annual % Change)	6.4	4.4	69.3	4.3	1.8	5.9	8.2
External Assets and Liabilities							
Gross External Debt (USDm)	17065	18353	21946	24707	25427	28697	31647
Gross External Debt (% of GDP)	100.0	99.4	109.8	113.0	112.9	121.3	125.5
Gross External Debt (% of CXR)	193.3	211.1	131.6	135.1	134.3	136.3	140.1
Net External Debt (USDm)	1538	618	-2007	-2380	-1379	362	2541
Net External Debt (% of GDP)	9.0	3.3	-10.0	-10.9	-6.1	1.5	10.1
Net External Debt (% of CXR)	17.4	7.1	-12.0	-13.0	-7.3	1.7	11.2
Public External Debt (USDm)	6018	8436	9255	8977	9447	10467	11667
Public External Debt (% of GDP)	35.3	45.7	46.3	41.1	41.9	44.2	46.3
Net Public External Debt (% of CXR)	-10.1	2.4	-28.7	-24.9	-22.7	-15.7	-8.3
Public FC Denominated & FC Indexed Debt (USDm)	9597	14586	15558	18367	18828	20226	21553
Short-Term External Debt (% of Gross External Debt)	65.9	59.7	56.6	54.8	53.2	54.1	53.8
External Debt Service (% of CXR)	14.6	13.7	8.4	10.1	11.1	12.6	12.1
External Interest Service (% of CXR)	9.4	8.5	4.7	4.2	5.9	6.9	7.2
Liquidity Ratio (%)[4]	121.5	104.4	117.9	140.9	147.2	139.0	132.9
Official International Reserves Including Gold (USDm)	6911	8231	14045	13534	13753	13782	13553
Official International Reserves in Months of CXP Cover	4.2	4.7	5.5	4.9	4.8	4.7	4.3
Official International Reserves (% of Broad Money)	12.4	13.4	23.8	20.1	19.4	18.9	17.5

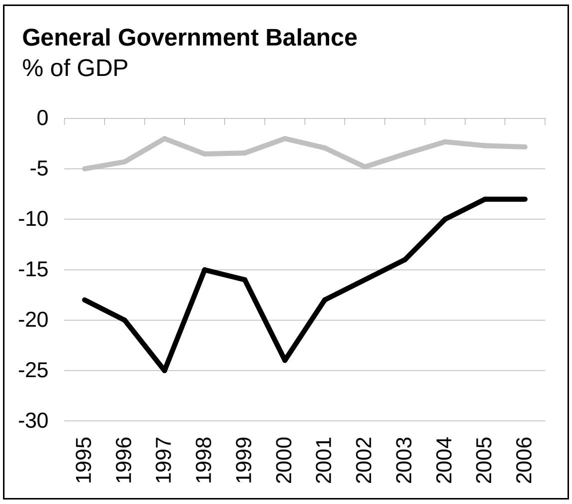
[1] 3-month LBP t-bills (annual average)
[2] Maturities of medium and long-term debt during year plus short-term debt outstanding at the beginning of the year
[3] Current account balance plus amortisation of medium and long-term debt, over official international reserves
[4] Official reserves including gold plus banks' foreign assets/ Debt service plus liquid external liabilities

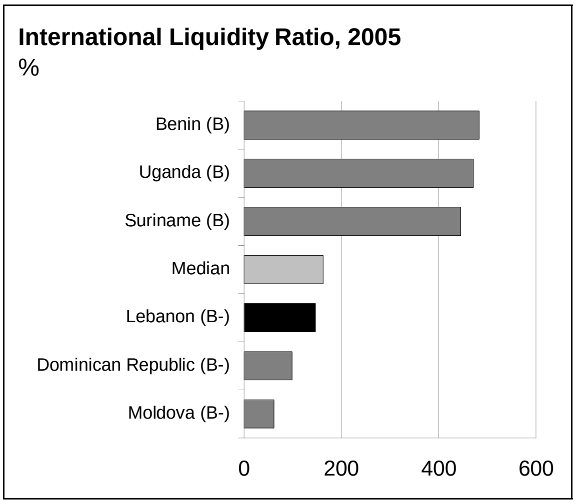
Peer Comparison

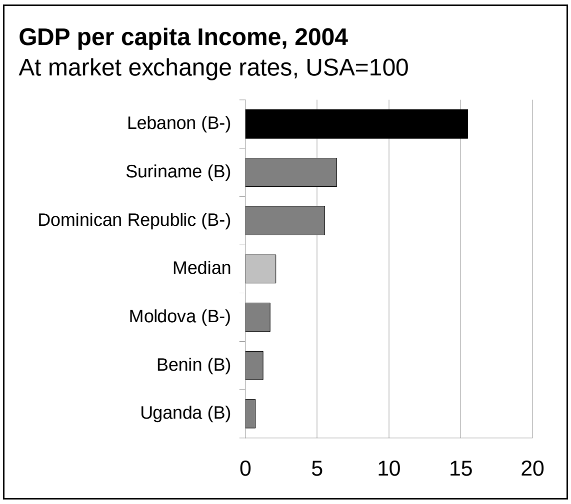












Lebanon B Median

Source: Fitch Sovereign Comparator

Rationale

Fitch assigned a Positive Outlook to Lebanon's 'B-' (B minus) foreign and local currency Issuer Default Ratings in November, reflecting its judgement that the government that came to power in June is more likely than not to formulate and gain political support for an economic and structural reform programme which will attract financial support from key donors early in 2006. Implementation of such a programme, which is expected to combine fiscal adjustment and growth enhancing structural reforms, would bring a renewed decline in the key public debt ratio which fell in 2003-4 but rose again in 2005.

The Positive Outlook does not mean that the reform process that Fitch expects to gather momentum in coming months will be without challenges and setbacks. The political system is going through unprecedented change after the assassination of former Prime Minister Rafik Hariri in February 2005. The reduction of Syrian influence over political and economic decision making, after the withdrawal of troops and intelligence personnel in April, of itself makes reforms more likely. But the political situation remains complex and fragile and a continuing drag on Lebanon's ratings. The system is still open to manipulation for sectarian and personal interests and although the assassination of former PM Hariri has changed the political centre of gravity, the ruling coalition is by no means homogenous and has the potential to unravel. Continuing foreign pressure on Syria could provoke responses with the potential to destabilise the uneasy political equilibrium. That said, the system has survived a major stress test in 2005 and although further shocks cannot be ruled out, these risks are already well encapsulated at the current rating level.

The economic programme has yet to be finalised. First intentions seem ambitious but given the political sensitivity of some of the issues that need to be addressed, such as petroleum subsidies, the losses of the electricity company (EdL) and privatisation, the programme is likely to be modified in cabinet and by Parliament. Challenges at the implementation stage are also likely. Political support for and implementation of the programme will be paramount to the progress of Lebanon's ratings.

The failure of the previous government to deliver on commitments after the Paris II conference in late 2002 has severely eroded government credibility. However, Fitch believes that the chance of reforms being implemented are significantly higher now. Firstly, the government has demonstrated that it can implement a major fiscal adjustment. Few sovereigns can match the almost 10% of GDP improvement in the primary surplus seen between 2001-3. The new government has already achieved an increase in the primary surplus of two-thirds in Q3 compared to the first half. Secondly, there is a greater consensus for reform, which the government aims to encourage with popular consultation. Domestic politics shows some early signs of a more conventional pattern, with MPs taking more account of their constituents' interests. Moreover, the ability of key opponents of structural reform, especially privatisation, to block progress is significantly reduced in the new political balance. Finally, mindful of the experience after Paris II, both the government and potential donors envisage phased financial support alongside programme implementation.

The improvement in the primary balance in 2001-3 was sustained in 2004 and, combined with a strong revival in GDP growth to 5%-6% in 2003-4, the public debt burden declined by a cumulative 6% of GDP in these two years – the first decline in over a decade. The events of 2005, combined with some pre-funding, have reversed this decline, raising public debt to almost 170% of GDP again. However, the deterioration slowed in the second half as the new government re-asserted spending control and revenues responded to a more stable economy. With the regional economic environment remaining supportive, as evidenced by renewed deposit inflows into Lebanese banks and investment in the property sector, Fitch expects growth to revive in 2006-7, although at a moderate 3%-4% pace. Against this background, assuming the primary surplus is restored to 2½% of GDP next year and rises to 3% of GDP in 2007, a cumulative fiscal adjustment of 1.8% of GDP, public debt would begin to fall again. That said, a situation in which debt interest absorbs over 40% of revenues, albeit a ratio halved over the past four years, is hardly a sustainable one and demands more than just stabilising the debt burden. Domestic and external financing needs are huge and although met so far, with an impeccable debt service record, are clearly reliant on continuing support from the Lebanese diaspora, foreign donors and domestic banks. Vulnerability to adverse shocks remains high.

The government has an ambitious target for reducing the debt burden over a 5-year period. This will require a much bigger rise in the primary surplus – to 7% or 8% of GDP – and a reduction in the overall deficit from around 8% of GDP this year to nearer 3%, together with debt refinancing operations, concessional donor assistance, as well as mobilisation of assets, including privatisation. With one of the highest debt burdens in the universe of rated sovereigns, demonstrable progress towards reducing the public debt ratio is essential to support a rating upgrade.

Meanwhile, structural reforms are needed to raise productive potential and competitiveness in order to stimulate investment and growth while reducing Lebanon's huge current account deficit of around 20% of GDP. Although sizeable FDI has financed some of this, the external balance sheet continues to weaken, although Lebanon remains a net external creditor as 70% of eurobonds are domestically held. Lebanon is the lowest rated net external creditor but also has the largest current account deficit of any rated sovereign.

The ratings are supported by Lebanon's large banking system which holds half of all Lebanese government debt. The system has proved resilient to its biggest ever stress test. Non-resident deposits did fall after February and dollarisation rose to over 80%; both pressured reserves which fell by USD2bn. However, the starting point was quite robust, with reserves having reached an historic high in 2004, banking system liquidity traditionally high and the central bank providing effective management. A potentially catastrophic collapse of confidence was avoided. Deposits and reserves have subsequently surpassed pre-February levels. Nevertheless, Lebanon's ratings are potentially vulnerable to the systemic risk posed by high dollarisation and high sovereign exposure in the context of a currency peg which continues to be undermined by weak fiscal fundamentals.

The ratings are also supported by a relatively high level of per capita income and an unblemished debt service record. The intimate connection between the local currency and foreign currency sovereign debt markets and between banks and the sovereign explains Fitch's rationale for equating Lebanon's local currency, foreign currency and country ceiling ratings.

■ Political and Social Situation

The assassination of former Prime Minister Rafik Hariri in February was a political watershed. But as made clear in the report of Detlev Mehlis - head of the team set up by the UN Security Council to investigate the assassination - it was Syria's decision in September 2004 to impose an extension of Lebanese President Lahoud's term, immediately preceded by a UN Resolution demanding an end to external interference in Lebanon, that were the catalyst for the events leading up to the assassination.

The event prompted unprecedented pro and anti Syrian demonstrations on the streets of Beirut. Under increasing international pressure, Syria withdrew its troops and security forces from Lebanon in April, allowing parliamentary elections to take place without Syrian influence for the first time since the Civil War.

Lebanon's Constitution preserves a delicate balance between 18 different confessions. The President is a Maronite Christian; the PM is a Sunni Moslem; and the Speaker of parliament is a Shia Moslem. Meanwhile, the electoral system guarantees an even split between Christian and Moslem MPs. The President is elected by Parliament and the latter by a list system. After much controversy, elections went ahead as scheduled in May/June under the 2002 electoral law. [1] This features constituencies of varying size which, within the constraints of the 50/50 denominational split, had tended to produce a pro-Syrian majority. With Syrian influence significantly reduced, however, the same electoral system produced an anti-Syrian majority, though retaining significant representation for groups traditionally allied to Syria.

The main parliamentary factions are:

- The Future block, led by Rafik Hariri's son Saad, which was elected mainly from Beirut, North Lebanon and West Bekaa;
- The Lebanese Forces/Qornet Shahwan/Phalangists (mainly Christian) elected from various areas and allied with the Future block
- The two blocks Amal and Hizbollah (mostly Shiite), elected mainly from the south of Lebanon, southern Beirut and the North Bekaa;
- The Aoun block (mainly Christian), elected mainly from the northern part of Mount Lebanon

The governing coalition brings together the Future block, which includes Walid Jumblat's Druze faction, together with Hizbollah, which enters government for the first time and provides two ministers, including the key energy ministry, and the Amal block. Parliament nominated as Prime Minister Fouad Siniora - Finance Minister in the previous Hariri government – whose cabinet was then eventually approved by the President before winning a vote of confidence in Parliament. Ironically, the Aoun block, which strongly supports the type of reforms that Siniora is pressing for, was not able to negotiate acceptable terms for its participation in government. The coalition therefore relies on the support of Amal-Hizbollah, which reduces its internal coherency.

[1] A committee is currently tasked with producing proposals for a new electoral law early in 2006

Tension between President Lahoud and former PM Hariri were the main reason why previous reforms fell short of ambitions, most obviously in the case of privatisation of the two lucrative mobile telecom networks. Political developments since the Hariri assassination have left the President in a fairly isolated position, less able to block such reforms. He has refused to resign and will likely remain in post unless a two–thirds majority of Parliament votes to begin an impeachment process. Rivalry between the President and PM could re-emerge, to the detriment of economic policy coherence. But even without that scenario, the reform programme will remain hostage to coalition politics and personal interests. Although no political faction is overtly hostile to reform, other issues have the potential to attract higher political priority and divert time and energy away from economic and structural reforms.

The most obvious political issues are the Mehlis investigation and relations with Syria; the status of Hizbollah; and Palestinian refugees. Syria has denied involvement in the murder of Hariri and subsequent political assassinations. But the Mehlis report has implicated several senior Syrian officials, five of whom have recently been questioned, and the Security Council is considering how best to ensure full Syrian co-operation. The Syrian regime will remain under pressure and a number of scenarios can be envisaged. From a credit point of view, the worst case scenarios are that political assassinations continue, creating a climate of fear which diverts attention from economic reforms and makes them more difficult to implement. Business and consumer confidence would suffer. More extreme scenarios can be envisaged. On the positive side, Syrian co-operation with the Mehlis commission could intensify and the regime could ultimately re-orient its policies in order to reduce its international isolation. At the other extreme, the security and economic situation in Lebanon could deteriorate anew and/or the Syrian regime could collapse into chaos. Syria could respond to potential UN sanctions by putting sanctions on Lebanon, with Syria a key export route for Lebanon. Suffice to say, political risk remains extremely high in Syria and therefore in Lebanon, to the extent that although Lebanon's ratings could improve, they will remain firmly in the B category for the foreseeable future.

■ Short-Term Prospects

Although data quality and availability is gradually improving, shortcomings in national accounts and price data continue to hamper analysis of recent developments. National accounts have recently been extended to 2002 but subsequent figures derive from various sources, brought together by the IMF. There are no quarterly data and assessment of current year developments relies on a variety of monthly indicators. There is no official consumer price index.

Despite the lack of firm data it is nevertheless fairly clear that 2003-4 witnessed the strongest period of growth in Lebanon since the mid-1990s, while inflation remained subdued. The IMF estimates GDP growth of 5-6% in these two years, largely externally driven. The weak USD, to which the LBP is pegged, boosted export competitiveness while high oil prices, although raising the import bill, brought benefits in the form of increased tourism and workers remittances and capital inflows in the form of non-resident deposits and investment in the property sector. Inflation rose slightly in 2004, due to higher import prices, but fell back in 2005 as growth slowed.

Economic Performance and Outlook

(%)	2004	2005e	2006f	2007f
Real GDP	6.0	1.0	3.0	4.0
CPI Inflation (% Annual Avg.)	3.0	2.0	2.0	2.5
Budget Balance (% GDP)	-9.8	-8.0	-7.9	-7.1
Current Account (% GDP)	-21.9	-20.3	-16.2	-17.2

Source: IMF, MoF, BdL and Fitch

The current slowdown dates from the increased political certainty prompted by the extension of President Lahoud's term in September 2004. Activity then slumped after the February assassination of former PM Hariri, and although the second half of 2005 has seen some revival, GDP for the year as a whole was virtually stagnant. The IMF puts GDP growth and inflation in 2005 at zero and 1% respectively. Our estimates are 1% higher in both cases, based on the central bank's coincident indicator and available price indices. There are no unemployment data.

Activity is expected to continue recovering in 2006-7 at a pace depending on the impact on confidence of the reform programme, expected to be finalised in the first quarter. The authorities have based their medium-term projections on a nominal growth assumption of 5%, which implies real growth of 3%-4%. Sustaining growth at a faster level will rely on the implementation of structural reforms. Inflation is assumed to remain subdued, although it is likely to pick up slightly, especially if indirect taxes are increased and/or a start is made to reducing petrol price subsidies.

■ Structural Issues

The government is formulating a comprehensive reform programme featuring an up-front fiscal adjustment, described in more detail later; structural fiscal reforms such as pension reform, that will have a longer-term impact on public finances; measures to raise growth through modernisation of the economy, enhanced competition, privatisation etc.; improved governance; and an enhanced social safety net with better targeted public spending. Precise details have yet to be agreed at the political level and some of the more ambitious ideas may be watered down in cabinet and parliamentary discussion. An outline has been shown to donors. Financial assistance of a similar order of magnitude to Paris II i.e. USD3-4bn, primarily in the form of soft loans, has been mentioned but the precise amount will depend on the final shape of the package. The banking sector is likely to make a voluntary contribution. Assistance will be phased according to implementation, with the IMF likely to play at least a monitoring role.

Privatisation has been promised in the past and enabling legislation for the privatisation of telecommunications and electricity assets was approved in 2002. Some preparatory work has been undertaken, making swift progress possible if the political will is there. This will therefore be an obvious early test of political support for reform, which could bring substantial benefits both to economic efficiency as well as to reducing the debt burden. The two mobile telecom companies are currently privately managed and are obvious candidates for early privatisation. The government would, however, need to give six month's notice in order to break the current management contract. The contracts are also lucrative for the treasury. So although substantial amounts could be raised, up to 25% of GDP on some estimates, the short-term fiscal cost probably makes partial privatisation a more likely first step.

In the longer term the government is also contemplating the sale of the fixed line operator – Liban Telecom – but this will be contingent on its corporatisation and the establishment of a regulatory authority. A third mobile license is also likely to be sold eventually.

Modernisation of the loss making Electricité du Liban (EdL) is another major objective, though one which raises far more technical and political obstacles. The government hopes to make progress in 2006 with reducing technical losses in transmission and by arranging cheaper fuel supplies. Beyond that, improving its financial situation will require action to improve bill collection and reduce theft, both of which will be politically challenging. However, with current tariffs relatively high, there is scope for a trade-off combining tariff reform and improved collection.

A number of smaller assets, currently in the hands of the central bank, including Middle East Airlines and Casino du Liban, are also on the list for privatisation, with the proceeds going to BdL.

■ Financial Sector

The creditworthiness of the Lebanese sovereign and Lebanese banks are intimately linked. The banking system is large, with broad money (M3) and private sector credit equal to 216% and 76% of GDP respectively - both very high for emerging markets and even for many developed countries. Placement of even a "normal" fraction of bank deposits in government paper would support a higher than usual sovereign debt burden and this goes part way to explaining how Lebanon has been able to support such a high public debt burden. In fact, sovereign debt comprises around 20% of banks' balance sheets, which is high compared to an emerging market average of 15%, but by no means the highest.[2] But with such a large balance sheet in relation to GDP, the ratio of sovereign debt to broad money, at 76%, is less than the median for all rated sovereigns. The ratio peaked at 83% in 2002 but has since been broadly stable at 76%-78%. The central bank monitors a more sophisticated ratio, with market held debt as the numerator. This is lower than the broader measure but the trends are similar.

Key Facts: Banking System (2004)

M2 (% GDP)	215.9
Private Credit (% GDP)	75.6
NPL Ratio	12.2
Capital Adequacy Ratio	22.3
Public Ownership (% of Assets)	0
Foreign Ownership (% of Assets)	<20
Banking System Indicator (BSI)	D
Macro-Prudential Indicator (MPI)	1

Source: IMF, BdL, MoF, Fitch Estimates

On the other hand the banking system, which features high dollarisation (over 70% of deposits), highly indebted borrowers, and potentially volatile non-resident deposits (18% of deposits), all in the context of an exchange rate peg, represents a major contingent liability for the government. Although none of the major banks is publicly owned, the authorities are highly likely to support the major banks in the event of a sovereign crisis.[3] Loan quality is low, with gross NPLs over 12% of total loans; adding in doubtful loans doubles the ratio. Net NPLs are slightly lower and have fallen to less than 10% in 2005. Provisioning levels have also improved but in

[2] Taking account of holdings of BdL debt issues and other BdL liabilities raises broader "sovereign" exposure to over 50%

[3] Their ability to do so, however, is reduced by already fragile public finances. This explains the relatively low Support rating of '5' that Fitch has assigned to some of the major banks. This reflects both the sovereign's willingness and ability to support the banks

Fitch's opinion remain inadequate, at 68% of doubtful and substandard loans at end-2004. Over half of un-reserved NPLs have collateral backing. Net NPLs are smaller as a proportion of total assets of course – just 2% - since private sector lending is less than a quarter of all assets. By contrast, apparently high capitalisation of over 20% is flattered by the zero-risk weight applied to sovereign debt. Under Basel II guidelines, which BdL intends to introduce by 2008, risk weighting could rise to as much as 100% for foreign currency loans and 20% for domestic local currency loans. BdL is unlikely to go that far, but by way of illustration, a risk weighting of 20% for all sovereign debt would bring the capital adequacy ratio below the minimum 12%.

Fitch has assigned 'C/D' Individual ratings to two of the biggest Lebanese banks and from its knowledge of the rest of the system calculates the system average Individual rating also at C/D. Taking into account specific systemic risks – exposure to the sovereign, foreign currency lending, over extended borrowers and common lending and deposit concentrations, including non-resident deposits – Fitch judges the banking system in aggregate to have a Banking System Indicator (BSI) of D, denoting a relatively weak system.[4] With a high level of credit to GDP, this translates into a relatively high contingent liability for the sovereign.

Risks are mitigated, however, by the historical resilience of non-resident deposits and by banks' high liquidity. The biggest fall in deposits in any year was 20%. By contrast, liquidity substantially exceeds this: the formal requirement is for banks to hold 15% of deposits in BdL and a further 15% in other external liquid assets. In practice, liquidity currently exceeds 50%. By comparison, the fall in deposits after the assassination of Mr Hariri was a relatively modest 5%.

Information about the structure of non-resident deposits is hard to come by due to banking secrecy laws. Only around one-third are interbank. These are potentially more volatile as it is relatively easy for head offices to wind down exposure in response to a shock, simply by not renewing short-term deposits at maturity. The remaining two-thirds are largely non-resident Lebanese and other Arab depositors and have traditionally been stable. The level of Syrian deposits in Lebanese banks has been the subject of much conjecture: the most reliable estimate Fitch has been offered puts them at around 3% of total deposits i.e. around USD1½bn. A large proportion represents collateral for trade finance.

The banking system played its traditional buffer role in February/March 2005. Deposit dollarisation rose to over 80%, compared to a more normal figure of less than 70%, involving the switch of USD6bn of deposits from LBP into USD. However, only USD2bn of this left the country. BdL provided the banks with USD assets in the form of a USD2bn CD issue which gave banks a domestic home for their increased USD deposits while at the same time restoring international reserves.

The resilience of the banking system and financial markets in the face of what is generally agreed was its biggest ever stress test was partly due to the government's success in at least stabilising the debt situation in recent years. It also reflects the relatively strong starting point, with reserves at an all time high in mid-2004. This contrasts to the position in the run-up to Paris II when the debt burden was rising rapidly and reserves were much lower. A serious crisis was only prevented at that time by donor support.

■ Public Finance

Lebanon has successfully stabilised its public debt since 2003, but at an unsustainable level. Until 2002, public debt rose inexorably as a ratio to GDP and broad money, the latter being a more useful indicator of debt sustainability given the role of the banks as holders of half of all public debt and the uncertainty of national accounts estimates for recent years. Since 2002, both ratios have improved slightly, despite the setback this year. Interest payments as a proportion of fiscal revenues have fallen much more sharply, from a peak of over 90% in 2001 to just over 40% in 2005. However, this remains amongst the highest of any rated sovereign, with only Turkey having a ratio at all comparable. Although fiscal revenues of a little over 20% of GDP are not low by emerging market standards, the large proportion spent on interest and wages leaves little room for investment in infrastructure and social provision.

The improvement in debt dynamics since 2002 reflects an almost 10% of GDP switch from primary deficit to primary surplus, a reduction in effective real interest rates, and some improvement in growth. 70% of the primary adjustment reflects a sharp fall in spending in 2001; the remainder reflects improved revenue performance from 2002, largely due to the successful introduction of VAT which now contributes 5% of GDP. Interest payments were lowered substantially by the concessional financing

[4] See "Assessing Bank Systemic Risk", July 2005. Banking systems are categorised on a scale from A (very high quality) to E (very low quality) with most emerging markets falling into the D category

made available by Paris II.[5] Average interest paid has fallen by 5 percentage points since 2002.

The fall in the debt ratio will be interrupted this year, due to the slump in growth and its impact on revenues in particular. There has also been an element of pre-funding. Fitch expects the primary surplus to fall by about 1% of GDP, due entirely to weaker revenue performance. However, interest payments will continue to fall as a percentage of GDP so that the overall budget deficit is estimated to fall to 8% of GDP. Moreover, the rise in the debt ratio will be relatively modest, staying within the 165%-170% range established since 2001.

The debt arithmetic is such that only a modest fiscal adjustment and revival of growth would set the debt ratio falling again. As a baseline, Fitch assumes the primary surplus is restored to 2½% of GDP next year and 3% in 2006. Higher interest rates will largely offset this adjustment, with the overall deficit stable at 8% of GDP and the public debt falling only marginally. However, 2007 would see the resumption of deficit and debt ratio reduction, helped by an assumed further acceleration of growth.

Lebanon's fiscal outlook is highly sensitive to assumptions made about growth, interest rates and the fiscal stance. It is not difficult to devise scenarios with escalating debt ratios, although these would have to assume an easing of fiscal policy and/or sharply higher interest rates and lower growth, which does not seem very likely at present. The key question is how ambitious a fiscal adjustment the authorities are able to implement in the short and medium term and what further reduction in debt might be generated by concessional assistance and privatisation proceeds.

Details of the government's fiscal programme have yet to be agreed. However, Fitch understands that the initial proposal is an upfront adjustment almost double the 1% of GDP assumed in the figures underlying this report. The latest IMF Article IV mission recommended an adjustment equivalent to 2½% of GDP in 2006 and a further 2 percentage points in each of 2007 and 2008. The government intends continued increases in the primary surplus, combined with concessional refinancing of existing debt and privatisation, to reduce the public debt ratio substantially over a five year period. Assuming an increase in the primary surplus to 8% of GDP, which would imply the overall deficit eventually settling at 3%-4% of GDP, Fitch calculates that the debt ratio would fall below 150% of GDP. The ratio would be reduced further by concessional assistance and/or privatisation.

Many of the areas that need to be addressed are well known and were included in the draft 2005 budget by Mr Siniora when he was still Finance Minister in the Hariri government. Key issues include the petrol price cap, introduced in May 2004 and reflected in reduced excise revenues, and the losses of EdL, currently running at 4% of GDP. Given the political sensitivity of these two elements, progress is likely to be gradual. In the short-term, tax revenues may be increased by raising VAT and the newly introduced tax on interest. Wage restraint and some initial attempts to curb pension costs would put downward pressure on current spending. There are plans for a General Income Tax in 2007.

The events of February 2005 showed once again the potential vulnerability of public finances to rollover risk. With depositors switching into USD, banks' demand for LBP debt dried up and since this is the government's main source of short-term funding, BdL had to step in to finance the government both directly, by purchasing t-bills, and indirectly by issuing CDs in its own name, which banks then bought. It also issued USD CDs later in the year to take advantage of increasing USD liquidity to replenish reserves[6].

Despite the pressures on the debt market this year, LBP debt has increased slightly and its maturity profile has lengthened. LBP denominated debt (50% of total debt) now averages more than 600 day maturity, with 3-year paper the most common issue (half the total). Approximately one-third of the outstanding stock (around USD6bn equivalent) amortises in 2006. Outstanding USD denominated debt, mainly eurobonds, has been largely unchanged in 2005 with USD2.5bn in new issues offsetting amortisation. The authorities had successfully reduced 2005 maturities with a swap operation in 2004 and had pre-financed some maturities with a USD1bn issue in February. A USD750m issue in October was heavily oversubscribed, with a much greater participation by foreigners than of late. Maturities in 2006 are USD2.5bn with USD1.1bn of this in April. The authorities have not yet decided whether to refinance this with a new issue, or a swap or from prospective donor funds. Most of the holders are domestic. The average maturity of eurobond debt is just under six years with amortisation falling to USD1.5-USD2bn in 2007-10.

[5] Details are available in Fitch's June 2004 sovereign report

[6] BdL made direct loans to EdL in 2004

Monetary & Exchange Rate Policy

Maintaining the peg to the US dollar, in place since 1998, is the overriding policy objective. Confidence in the peg is closely related to the level of international reserves, which reached an all time high in mid-2004 and despite falling by USD2bn in February/March 2005 have since recovered to end-2004 levels and are only USD1bn short of their all time high. The official presentation flatters gross reserves somewhat. Reserve assets include BdL eurobond holdings and the counterpart to banks foreign currency reserve requirements. Net reserves have at times been negative.

Interest rates follow US rates but have not risen as much as US rates this year due to high market liquidity. Secondary market trading of LBP debt is limited, allowing the authorities more control over rates. Rates change infrequently; they were largely unchanged in 2004, then increased across the board in March and April but have not changed since. Deposit rates are also sticky. Interbank rates are the most market determined and increased to an average 10.1% in March but have since fallen back below 4%. The average rate paid on LBP debt has increased gradually from around 6% at the start of 2005 to around 7.5% now.

External Finance

The IMF has recently published detailed balance of payments data for 2002-4 showing a much higher current account deficit – 22% of GDP in 2004 – than previously estimated. In the absence of official figures, Fitch has always made use of IMF estimates. Figures before 2002 have been revised by Fitch in light of the new IMF actuals.

The new data confirm a large trade deficit and a smaller deficit on net income, partly offset by surpluses on services and transfers. These reflect the importance of tourism and remittances from expatriate Lebanese. The current account deficit narrowed sharply last year from 27% of GDP in 2003. This was despite a sharply higher trade deficit as imports surged with higher economic growth and oil prices. This was offset by reduced income payments and higher inward transfers. There are no recent quarterly balance of payments figures and our estimate for 2005 is largely based on developments in the trade figures. The trade deficit has stabilised this year with both exports and imports sluggish. Tourism suffered in the aftermath of the Hariri assassination but we estimate this was offset by higher transfers, leaving the current account deficit unchanged at around 20% of GDP.

Although FDI into Lebanese property is sizeable, amounting to almost USD2bn in 2004 and financing 40% of the current account deficit, FDI outflows have also been increasing. Net equity investment in 2004 amounted to 4% of GDP – not insubstantial but dwarfed by the size of the current account deficit. Debt is the main financing source therefore, comprising official eurobond issues and non-resident inflows into banks. Official reserves have nevertheless fallen persistently in 2002-4, although valuation changes have caused the stock of reserves to rise.

Lebanon remains a net external creditor on a residency basis, as 70% of government foreign currency denominated debt is held domestically, mainly by banks. However, the net creditor position continues to weaken and could switch to a net debtor position next year if current trends persist, even with a projected slight narrowing in the current account deficit. The public sector would remain a net external creditor, albeit a declining one, but bank external liabilities would continue to exceed external assets, due to domestic onlending in USD.

Fitch estimates Lebanon’s overall external debt to be around USD25bn at the end of 2005. Although sovereign eurobonds amount to about USD16bn, only about USD5bn are counted as external debt i.e. after netting off those held by domestic banks and BdL. Of this USD5bn, over USD2bn is held by bilateral donors as part of the Paris II process. Thus, external market holdings of eurobonds amount to less than USD3bn. The biggest single component of external debt is in fact non-resident deposits (around USD10bn). Public sector non-eurobond debt (mainly bilateral) is about USD4½bn while other private sector debt amounts to about USD6bn - mainly bank borrowing.

Because of the large difference between foreign currency denominated debt and external debt, traditional debt service indicators are less relevant and are also difficult to estimate on a residency basis. Creditworthiness is more focussed on overall public finances and public debt sustainability. For example, sovereign foreign currency debt service is more than double sovereign external debt service and Fitch’s conventional liquidity ratio of 150% at the start of 2005 understates the demands on reserves bearing in mind that these must potentially meet all foreign currency obligations and not just those held by foreigners. Reserves must also be held to cover potential conversion of LBP deposits into cash in a crisis. Reserves are less than 20% of M2.

Public Sector Foreign Currency and External Debt Service (Medium and Long-Term Debt)

(USDm)	2002	2003	2004	2005e	2006f	2007f
Amortisation (All Foreign Currency)	**295**	**1,115**	**3,006**	**2,230**	**3,029**	**2,069**
Eurobonds	119	950	2,613	1,800	2,499	1,469
o/w to Non-Residents	24	196	473	310	430	253
Other Foreign Currency Debt	176	165	393	430	530	600
Interest (All Foreign Currency)	**892**	**1,171**	**1,178**	**1,210**	**1,374**	**1,497**
o/w to Non-Residents	559	678	600	616	700	762
Total Foreign Currency Debt Service	**1,187**	**2,286**	**4,184**	**3,440**	**4,403**	**3,566**
o/w to Non-Residents	759	1,039	1,466	1,356	1,660	1,615

Source: Ministry of Finance, IMF, Fitch

Fiscal Accounts Summary

(% of GDP)	2002	2003	2004	2005e	2006f	2007f
Revenue and Grants (excl. Priv'n)	**20.9**	**22.1**	**22.8**	**21.6**	**22.0**	**22.3**
o/w VAT	3.6	4.5	5.3	n.a.	n.a.	n.a.
Expenditure & Net Lending	**37.0**	**35.8**	**32.6**	**29.6**	**29.9**	**29.4**
Interest	16.9	16.2	12.2	9.3	10.2	10.2
o/w Foreign Currency	4.8	5.9	5.4	5.4	5.8	5.9
Primary Spending	20.1	19.6	20.4	20.3	19.7	19.2
Personnel	10.8	10.2	9.4	n.a.	n.a.	n.a.
Other Current	6.4	6.4	7.9	n.a.	n.a.	n.a.
Capital Spending	2.9	3.0	3.1	n.a.	n.a.	n.a.
o/w CDR (Externally Financed)	0.7	0.7	0.6	0.6	0.6	0.5
Primary Balance (Excl. Interest)	**0.9**	**2.4**	**2.4**	**1.3**	**2.3**	**3.1**
Overall Balance	**-16.1**	**-13.7**	**-9.8**	**-8.0**	**-7.9**	**-7.1**
Financing						
Local Currency	**-11.6**	**8.2**	**-3.7**	**6.0**	**2.0**	**1.9**
Foreign Currency	**27.7**	**5.5**	**13.5**	**2.1**	**5.9**	**5.3**
Public Debt	**169.9**	**166.9**	**164.0**	**168.5**	**168.3**	**165.0**
Local Currency	90.9	89.1	80.0	84.9	82.8	79.5
Foreign Currency	79.0	77.8	84.0	83.6	85.5	85.5
o/w Eurobonds	67.6	64.0	70.8	72.4	78.5	82.6
Public Debt (% of M2)	82.7	77.8	76.0	77.8	77.3	75.4
Public Debt (% of Revenue)	811.2	755.8	719.4	780.9	765.8	741.0
Memo						
Balance Excluding CDR	-15.4	-13.1	-9.2	-7.4	-7.3	-6.6
Interest Service (% of Revenue)	80.8	73.2	53.5	43.2	46.3	45.7

Source: Ministry of Finance, Fitch estimates and forecasts

Balance of Payments

(USDm)	2002	2003	2004	2005e	2006f	2007f
Current Account Balance	**-4,385**	**-5,463**	**-4,797**	**-4,579**	**-3,838**	**-4,336**
% of GDP	-23.8	-27.3	-21.9	-20.3	-16.2	-17.2
% of CXR	-50.4	-32.7	-26.2	-24.2	-18.2	-19.2
Trade Balance	**-4,962**	**-5,223**	**-7,105**	**-7,157**	**-7,506**	**-8,038**
Exports	1,108	1,629	1,954	1,993	2,192	2,630
% Change	27	47	20	2	10	20
Imports	6,070	6,852	9,059	9,149	9,698	10,668
% Change	-10.7	12.9	32.2	1.0	6.0	10.0
Services, Net	**1,062**	**2,961**	**1,437**	**654**	**1,653**	**1,769**
Services, Credit	4,429	9,462	9,700	9,000	10,500	11,500
Services, Debit	3,367	6,500	8,263	8,346	8,847	9,731
Income, Net	**-563**	**-3,530**	**-845**	**-577**	**-485**	**-567**
Income, Credit	567	1,511	1,316	1,939	2,361	2,466
Income, Debit	1,131	5,040	2,160	2,515	2,847	3,033
o/w: Interest on Public Debt	559	678	600	616	700	762
Current Transfers, Net	**78**	**328**	**1,716**	**2,500**	**2,500**	**2,500**
Non-Debt Creating Flows, Net	**1,493**	**2,222**	**863**	**1,800**	**2,300**	**2,300**
Direct Investment, Net	1,336	2,268	1,047	1,500	2,000	2,000
Portfolio Equity Investment, Net	157	-47	-184	300	300	300
External Borrowing, Net	**2,756**	**5,152**	**5,498**	**720**	**3,270**	**2,950**
Net Lending Abroad	**-900**	**-4,081**	**-1,403**	**200**	**-1,600**	**-1,100**
Net Errors and Omissions	**-1,196**	**-1,861**	**-629**	**1,700**	**0**	**0**
Change in Reserves (-=Inc)	**2,219**	**4,002**	**340**	**31**	**-260**	**57**
Memo						
Gross Borrowing (Incl. Short-Term)	14,448	16,724	19,006	15,254	18,019	19,587
Gross External Financing Requirement	4,835	6,073	5,888	5,569	5,048	5,438
Stock of International Reserves, Excl. Gold	5,070	10,197	9,495	9,464	9,724	9,667

Source: IMF, MoF, Banque du Liban, Fitch estimates and forecasts

External Debt and Liquidity

(USDm)	2002	2003	2004	2005e	2006f	2007f
Gross External Debt	**18,353**	**21,946**	**24,707**	**25,427**	**28,697**	**31,647**
% of GDP	99.4	109.8	113.0	112.9	121.3	125.5
% of CXR	211.1	131.6	135.1	134.3	136.3	140.1
By Maturity						
Medium- and Long-Term	7,391	9,529	11,163	11,888	13,163	14,618
Short-Term	10,962	12,417	13,544	13,539	15,534	17,029
% Total Debt	60	57	55	53	54	54
By Debtor						
Public Sector	8,436	9,255	8,977	9,447	10,467	11,667
o/w Eurobonds	3,520	4,166	4,513	5,013	5,763	6,763
Non-Res Holdings of T-Bills	1,711	1,301	813	813	813	813
Non-Bank Private Sector	2,556	3,363	3,634	4,384	5,134	5,884
Banks	7,360	9,328	12,096	11,596	13,096	14,096
o/w Non-Resident Deposits	6,107	7,737	9,567	9,600	n.a.	n.a.
Gross External Assets*	**17,735**	**23,953**	**27,087**	**26,934**	**28,445**	**29,197**
International Reserves, Incl. Gold	8,231	14,045	13,534	13,881	13,892	13,644
Deposit Money Banks' Foreign Assets	9,504	9,908	13,553	13,053	14,553	15,553
Net External Debt	**618**	**-2,007**	**-2,380**	**-1,507**	**252**	**2,449**
% of GDP	3	-10	-11	-7	1	10
% of CXR	7	-12	-13	-8	1	11
Debt Service (Principal and Interest)	**1,193**	**1,400**	**1,856**	**2,109**	**2,661**	**2,740**
Debt Service (% of CXR)	13.7	8.4	10.1	11.1	12.6	12.1
Interest Service (% of CXR)	8.5	4.7	4.2	5.9	6.9	7.2
Liquidity Ratio (%)	**104.4**	**117.9**	**140.9**	**147.2**	**139.0**	**132.9**
Excl. Banks' Foreign Assets	35.1	41.0	71.4	60.7	58.4	53.2

* Non-bank private sector external assets are not taken into account
Source: Banque du Liban, Ministry of Finance, BIS, IMF, Fitch estimates and forecasts