# Lebanon (Republic of)

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## Major Rating Factors

| Sovereign Credit Rating |
| --- |
| CCC+/Stable/C |

**Strengths:**

- Sizable and resilient resident and nonresident deposits in Lebanon's financial sector enabling Lebanese banks to meet the government's financing needs
- Strong financial support from wealthy Gulf Arab states
- A comparatively developed economy that--in better political circumstances--would be 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 public sector debt burden that severely constrains fiscal flexibility
- Weak prospects for meaningful economic reform

## Rationale

The ratings on Lebanon reflect the political impasse that has raised tensions within Lebanon, and for which no easy resolution appears in sight. This stand-off has increased political instability, which could shake confidence in the financial sector, thereby compromising domestic banks' ability to lend to the government, and could delay reforms crucial for putting Lebanese public finances on a more sustainable path.

That said, several factors continue to support Lebanon's creditworthiness. The fiscal outturn in 2007–-a primary surplus of above 3% of GDP--was better than the IMF had targeted in its Emergency Post-Conflict Assistance program (EPCA), and the ratio of debt to GDP declined. Resident banks, which are by far the government's largest creditor, have continued to buy government debt despite their stated threats to desist unless the political confrontation is resolved and economic reform launched in earnest. Incremental bank funding of government deficits is still possible because, thus far, confidence in the currency and in the banking system has proven resilient to the political difficulties. This confidence is underpinned by prudent treasury management, with a fiscal buffer averaging $1 billion in 2007. There remains a strong possibility that foreign supporters of the Siniora government, primarily from among Gulf Arab countries, will step in to provide further financial aid. Moreover, the authorities met most of the targets set for 2007 under the EPCA program--largely preparatory steps for more far-reaching reform.

Nevertheless, these supporting factors threaten to be eclipsed by the political crisis. Despite a stated consensus that the head of the army, Michel Suleiman, should become the next president, deep divisions between the ruling March 14th coalition and the opposition (comprising primarily Hizbullah and the Free Patriotic Movement of former army general Michel Aoun), and between their respective external supporters, are preventing his election and the formation of a proposed national unity government. Consequently, the risk of instability has in our view increased, and with it the risk of capital flight. This would put pressure on the Lebanese pound's peg to the dollar and undermine the banks' capacity to lend to the government.

A protracted stand-off between the factions might also delay the passage of the most important economic reforms promised at the Paris III donor conference held in January 2007. These reforms are an essential starting point to redress precarious public finances, with general government debt remaining above 170% of GDP--one of the highest ratios of any rated sovereign. These include the privatization of the state-owned GSM mobile phone networks, which has already been postponed until May, and an overhaul of the state-owned electricity company Electricité de Liban.

## Outlook

The stable outlook balances Lebanon's political and fiscal pressures against the likelihood of third-party support and the country's economic resilience. The ratings will be lowered should civil unrest break out or if the political deadlock causes protracted policy inertia. The ratings could be raised in the event of the election of a president and the formation of a cabinet by consensus accompanied by some success in advancing the program of economic reforms pledged at the Paris III conference.

**Table 1**

**Republic of Lebanon Selected Indicators**

| | 2010f | 2009f | 2008 | 2007 | 2006 | 2005 | 2004 | Median B 2008 |
|---|---|---|---|---|---|---|---|---|
| GDP per capita ($) | 7,295 | 6,897 | 6,534 | 6,161 | 5,841 | 5,728 | 5,626 | 1,801 |
| Real GDP (% change) | 4.0 | 3.2 | 1.8 | 2.0 | (0.5) | 1.0 | 6.0 | 5.1 |
| Real GDP per capita (% change) | 2.5 | 1.7 | 0.5 | 0.5 | (1.8) | (0.6) | 4.6 | 3.0 |
| General government balance (% of GDP) | (8.3) | (9.0) | (9.2) | (9.9) | (12.6) | (7.6) | (8.6) | (2.2) |
| General government debt (% of GDP) | 152.7 | 154.9 | 156.3 | 158.1 | 170.0 | 166.7 | 153.2 | 37.1 |
| Net general government debt (% of GDP) | 144.6 | 146.2 | 147.0 | 148.0 | 157.1 | 149.9 | 139.7 | 32.0 |
| General government interest expenditures (% of revenues) | 40.5 | 41.3 | 41.6 | 44.1 | 53.1 | 41.3 | 46.3 | 7.1 |
| Domestic credit to private sector and NFPEs* (% of GDP) | 70.5 | 70.7 | 71.6 | 74.0 | 77.5 | 75.7 | 77.3 | 24.2 |
| Consumer price index (average; % change) | 3.2 | 3.8 | 5.5 | 5.0 | 5.6 | 2.4 | 1.5 | 6.5 |
| Gross external financing needs (% of CARs and usable reserves) | 115.8 | 115.5 | 115.8 | 118.4 | 119.3 | 131.4 | 118.5 | 109.5 |
| Current account balance / GDP (%) | (8.0) | (9.2) | (9.8) | (10.2) | (5.9) | (10.3) | (19.1) | (5.1) |
| Narrow net external debt / CAR (%)¶ | (73.7) | (71.9) | (71.3) | (71.2) | (50.0) | (28.7) | (20.8) | 52.2 |

*Standard & Poor's estimates that, in a reasonable worst-case scenario, the government's contingent liability from a banking crisis could amount to 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.

## Comparative Analysis

- Lebanon's political risks exceed those faced by all 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 two years mean that Lebanon now faces the greatest challenges 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-/Stable/C; all references to ratings hereafter are to foreign currency sovereign credit ratings) and Ecuador (B-/Stable/C). The Bolivarian Republic of Venezuela (BB-/Stable/B) also offers a useful comparison. The Republics of Turkey (BB-/Stable/B) and Suriname (B+/Stable/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+/Positive/B). Since Lebanon is the only sovereign rated in the 'CCC' category, we have compared its performance to the 'B' median.

### Political risks heighten

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, Bolivia, and Venezuela heighten the risk of disruption in the implementation of economic policy. Lebanon's political landscape has, however, deteriorated 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 proved short-lived as, in the wake of the war with Israel whose outcome it interpreted as a victory, Hizbollah has emerged as a more assertive force in Lebanese politics. The dispute that has ensued is deep-rooted and its resolution will require the active participation of a range of external actors with deep differences of their own. At the very least, this is a substantial barrier to economic reform; at worst, it could point to unrest.

Like Turkey, Lebanon does now have a policy anchor provided by an IMF program. In normal circumstances external conditionality should prove a valuable anchor for policymaking, and strengthen the position of the reformist government vis-à-vis domestic opponents. However, Lebanon's domestic political scene is currently so polarized that the prospects for any far reaching reform seem remote.

### 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. Despite posting a primary surplus in 2007 (see chart 1), debt servicing requirements are such that Lebanon continues to post among the highest fiscal deficits and debt burdens of all rated sovereigns including its peer group (see chart 2). The conflict between Hizbollah and Israel in mid-2006 will prove a substantial fiscal burden into the medium term. Foreign support to meet reconstruction costs has been slow to materialize. Consequently, a substantial reduction in the debt stock seems out of reach. The stock of central government debt, at 171% of GDP at year-end 2007, is almost 3x that of the 'B' median (see chart 3). Central government interest payments have risen to an estimated 57% of government revenues, which is by far the highest among peers (see chart 4). In contrast, the interest burdens faced by Turkey, Uruguay, and Ecuador, which are the next largest, have all declined in recent years.

**Chart 1**

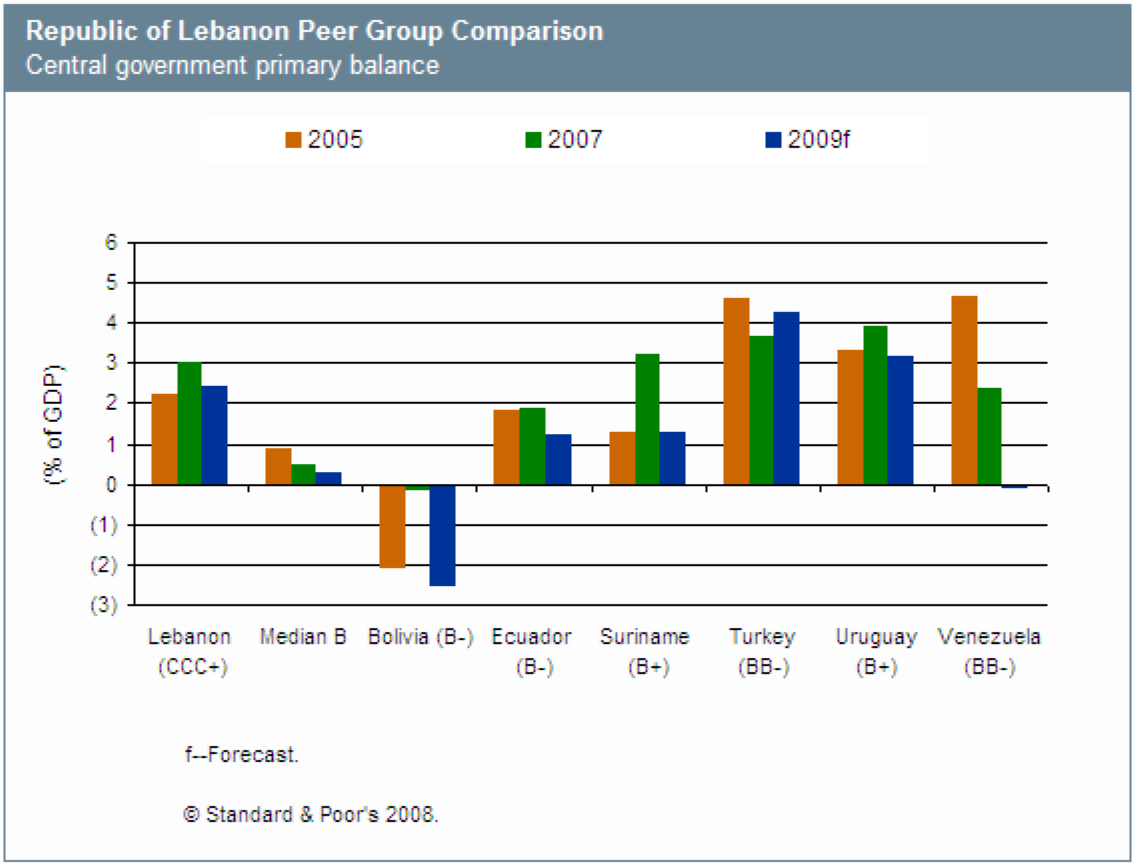

Republic of Lebanon Peer Group Comparison
Central government primary balance
2005
2007
2009f
6
5
4
3
2
1
0
(1)
(2)
(3)
(% of GDP)
Lebanon (CCC+)
Median B
Bolivia (B-)
Ecuador (B-)
Suriname (B+)
Turkey (BB-)
Uruguay (B+)
Venezuela (BB-)
f--Forecast.
© Standard & Poor's 2008.

**Chart 2**

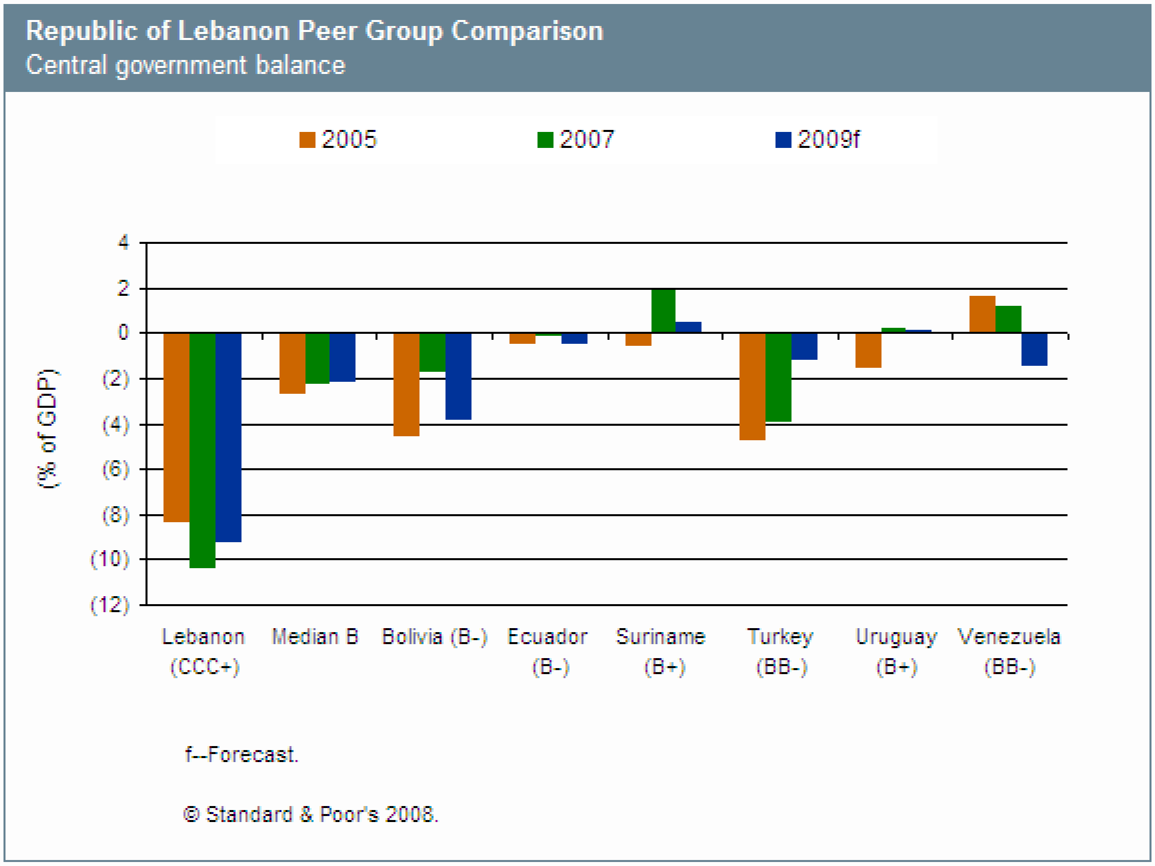

Republic of Lebanon Peer Group Comparison
Central government balance
2005
2007
2009f
4
2
0
(2)
(4)
(6)
(8)
(10)
(12)
(% of GDP)
Lebanon (CCC+)
Median B
Bolivia (B-)
Ecuador (B-)
Suriname (B+)
Turkey (BB-)
Uruguay (B+)
Venezuela (BB-)
f--Forecast.
© Standard & Poor's 2008.

**Chart 3**

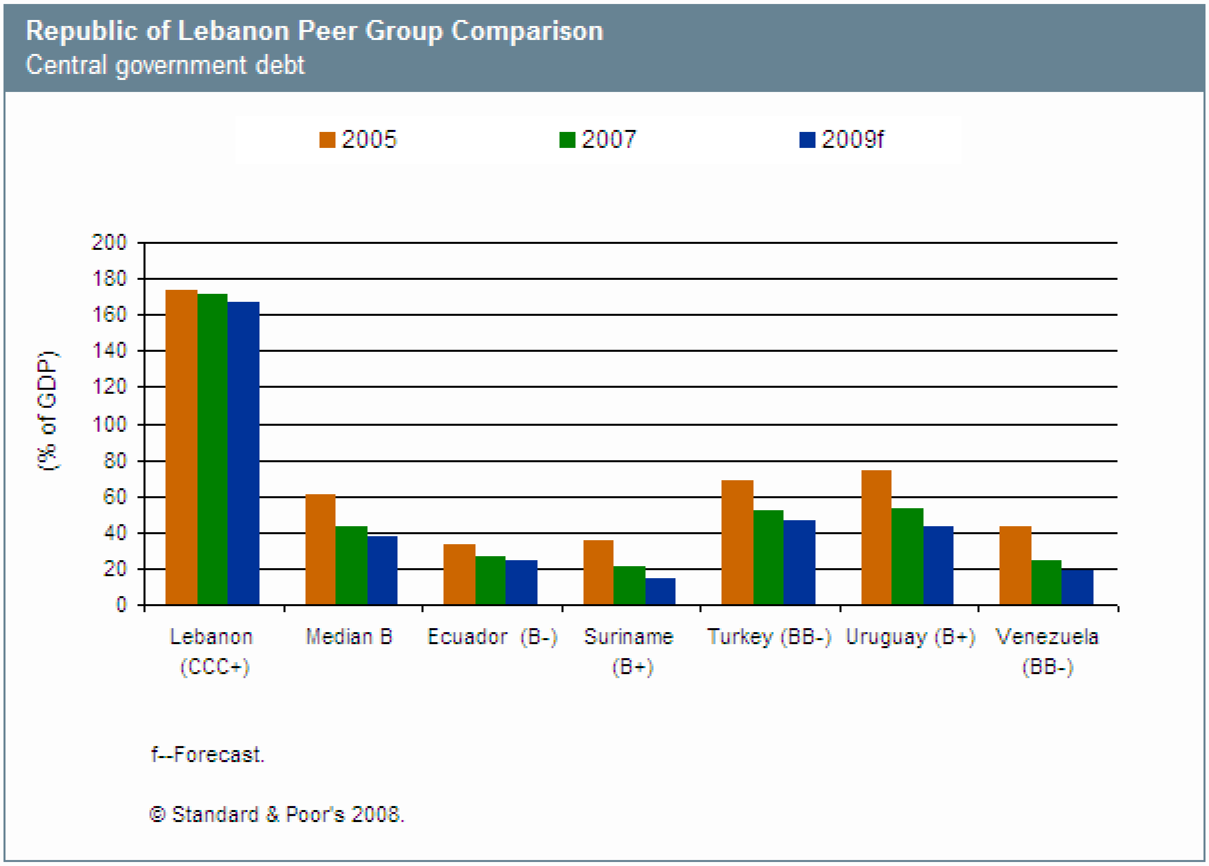
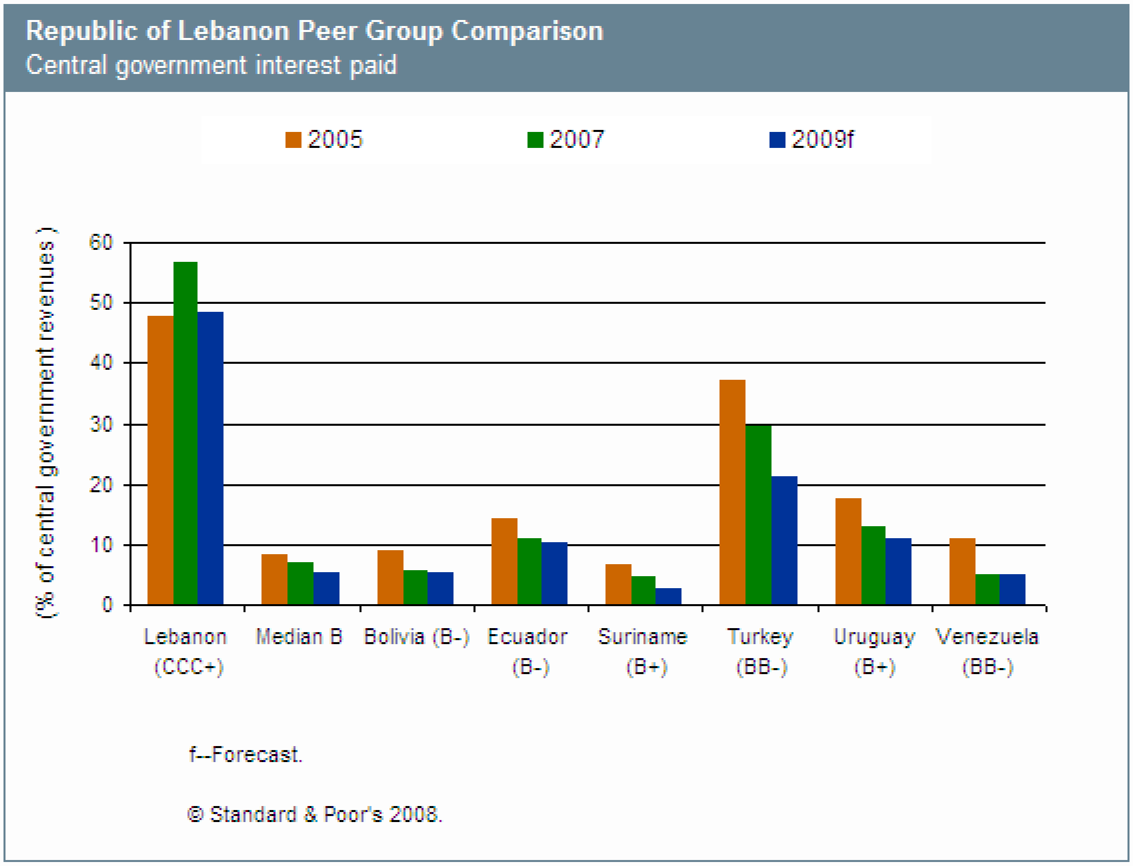

Republic of Lebanon Peer Group Comparison
Central government debt
2005
2007
2009f
200
180
160
140
120
100
80
60
40
20
0
(% of GDP)
Lebanon (CCC+)
Median B
Ecuador (B-)
Suriname (B+)
Turkey (BB-)
Uruguay (B+)
Venezuela (BB-)
f--Forecast.
© Standard & Poor's 2008.

**Chart 4**

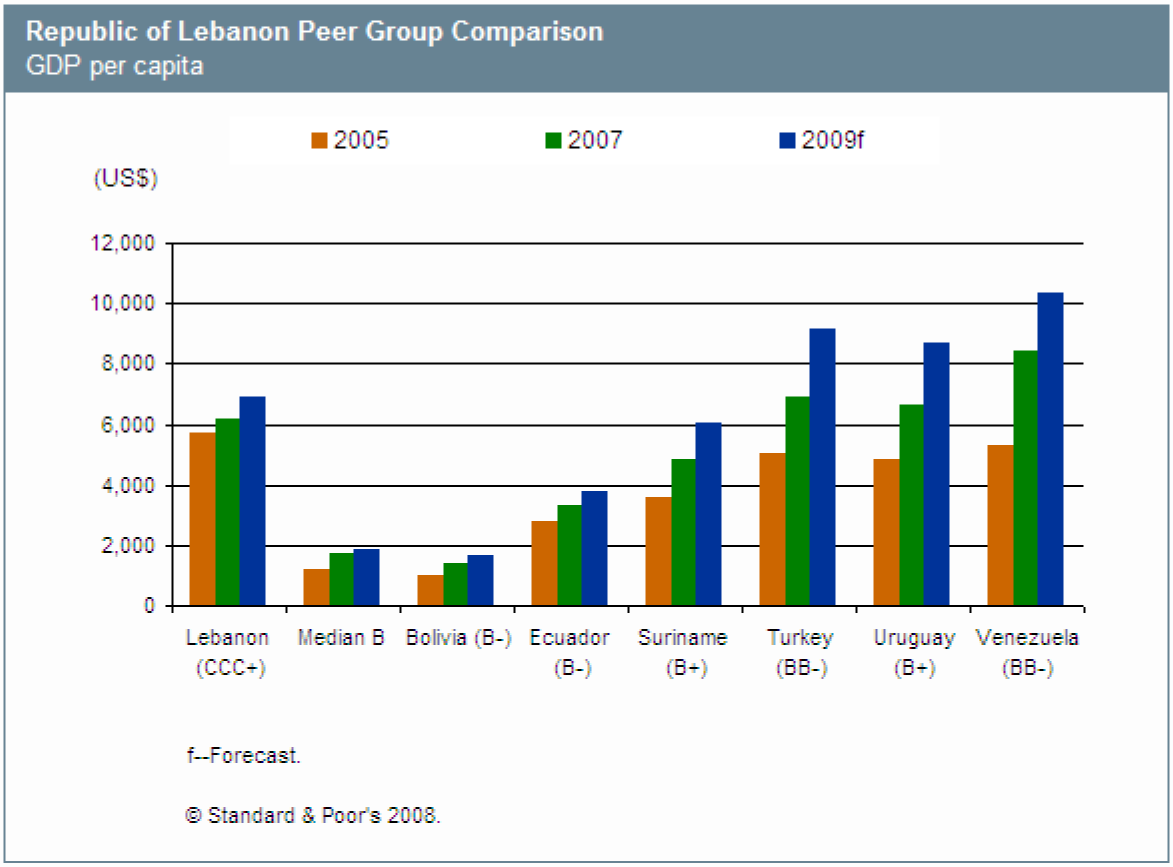



Unlike peers such as Ecuador and Suriname--which largely rely on access to official sources to meet their financing requirements--sizable resident and nonresident deposits in Lebanon's financial sector have enabled Lebanese banks to meet the government's financing needs. Unlike Turkey, nonresident holdings 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. Similar to Ecuador, Bolivia, and Uruguay, however, the Lebanese economy is heavily dollarized. In this regard, 76% of 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 more than 3x GDP. In a reasonable worst-case scenario, we estimate 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 lower than in Bolivia (35%-50%) and Ecuador (50%-75%). Furthermore, unlike in 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, estimated at $6,160 in 2007, far exceeds the 'B' median of $1,750 (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 88 out of 177 in the 2007/2008 U.N. Human Development Index, surpassing its peers in many more highly rated sovereigns including India, Egypt, Morocco, and Pakistan, although it ranks behind Turkey, Suriname, and Venezuela, and far behind Uruguay.

**Chart 5**




## External flexibility compares favorably to peers

Lebanon's current account deficit is the highest in its peer category, estimated at 10.2% of GDP in 2007. 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 to date shown remarkable resilience to political woes, as nonresident investors--many of Lebanese origin--are familiar with the risks present in the country and draw comfort from the apparent commitment of wealthy Gulf Arab states to ensure Lebanese financial stability. Lebanon's money supply (M3) of 2.4x the size of its economy, the strength of its banking sector, and usable reserves equivalent to seven 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 93%, 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.

**Chart 6**

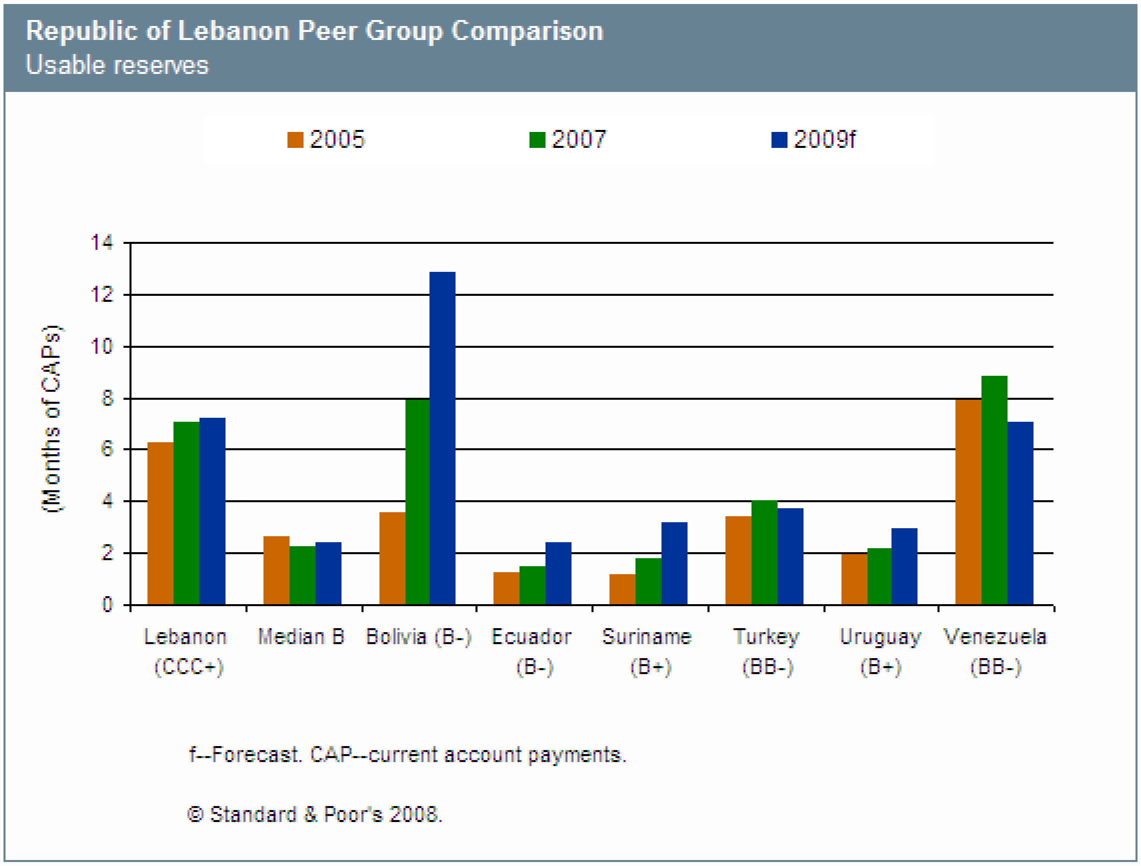
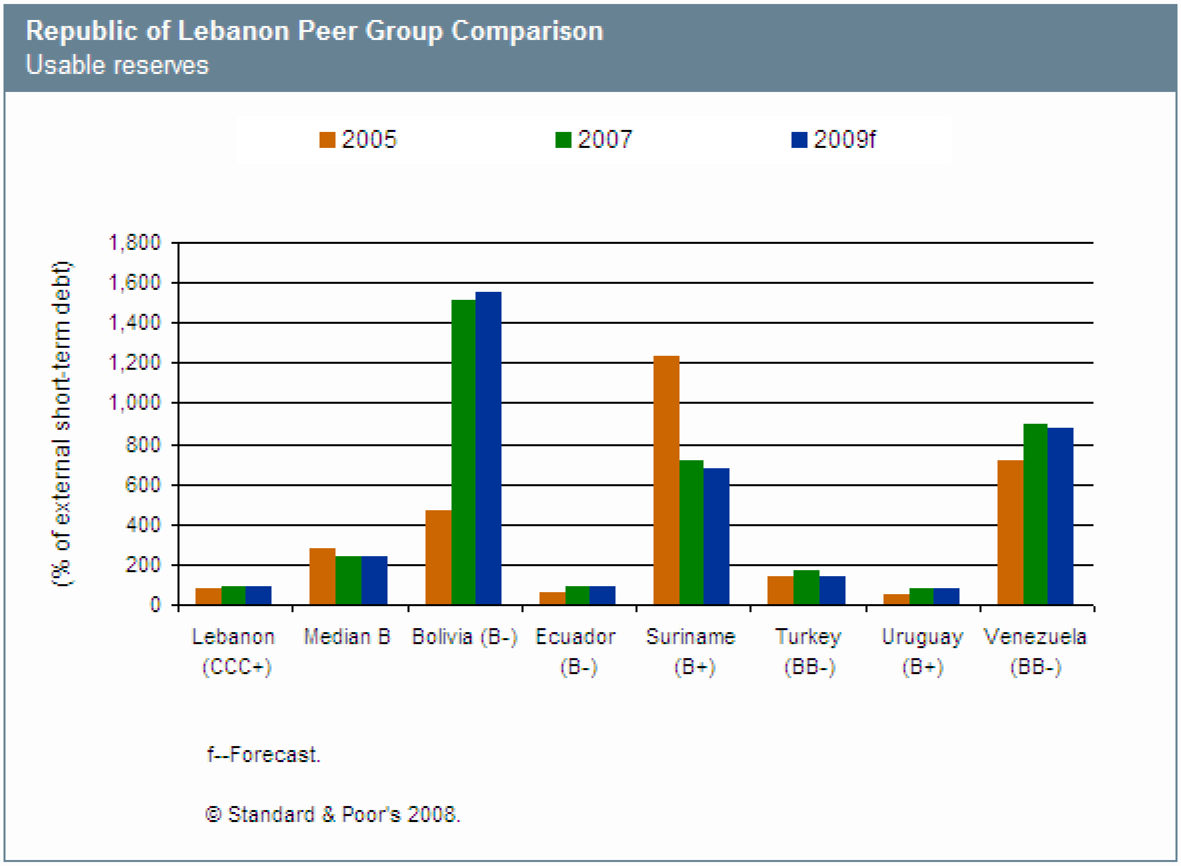
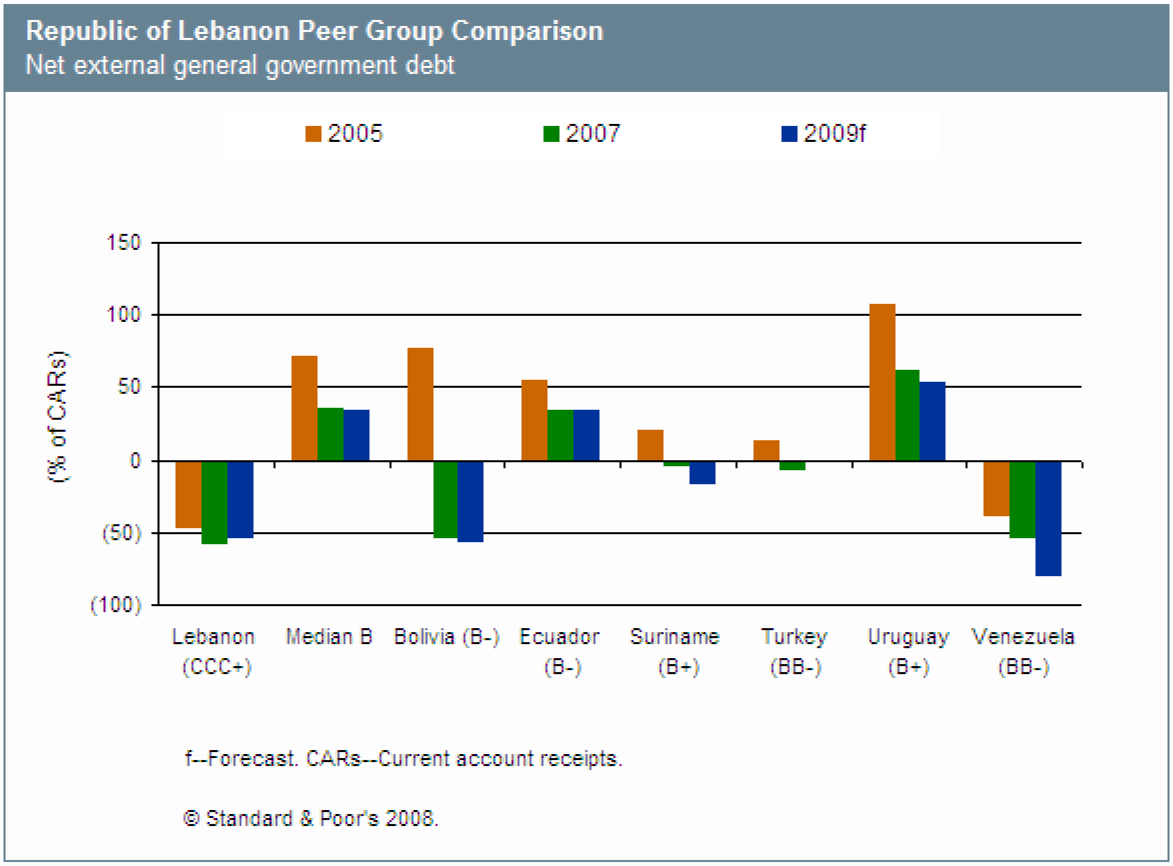

Republic of Lebanon Peer Group Comparison
Usable reserves
2005
2007
2009f
(Months of CAPs)
14
12
10
8
6
4
2
0
Lebanon (CCC+)
Median B
Bolivia (B-)
Ecuador (B-)
Suriname (B+)
Turkey (BB-)
Uruguay (B+)
Venezuela (BB-)
f--Forecast. CAP--current account payments.
© Standard & Poor's 2008.

**Chart 7**




The government's net external position also compares favorably among peers, despite the Lebanese government's foreign currency denominated debt estimated at 87% of GDP at year-end 2006. Lebanon's government holds a net external asset position of an estimated 58% of current account receipts (CARs) in 2007, as more than 90% of its debt, including both local and foreign currency, is held by resident banks and investors (see chart 8).

**Chart 8**




## Political Environment: The Struggle Intensifies

- No easy resolution appears in sight to the polarizing political dispute.
- The prospects for far-reaching economic reform seem slim.
- Gulf Arab countries are likely to continue to provide funds to the Siniora government.

Lebanon's divisive political system looks in greater peril 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 this optimism. Instead, subsequent events have resulted in a policy-making deadlock and raised significant concerns over 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 for the government into the medium term.

Potentially the most far-reaching legacy of the war, however, has been 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 popular praise it won in neighboring, predominantly Sunni, countries for resisting Israel, Hizbollah has sought 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 has pressed the ruling March 14th coalition for sufficient cabinet seats to veto proposed policies. The steadfast refusal of the Siniora government led to the resignation in late 2006 of Hizbollah and other opposition ministers and a sit-in in downtown Beirut aimed explicitly at bringing down the Siniora government.

The dispute came to a head over the selection of a president to replace Emile Lahoud, whose second term in office ended in November 2007. Neither camp followed through on threats that may have led to dual administrations, an outcome that would have divided Lebanese society and raised the specter of civil unrest. Instead, a consensus was eventually reached that the head of the army, General Michel Suleiman, should become the next head of state, overriding Aoun's long-standing ambitions. No faction wants to be seen as undermining national unity and Hizbollah consistently emphasizes its nationalist credentials. Yet Suleiman's election has been repeatedly postponed amid wider political disagreements, primarily over the make-up of the new cabinet. There is no easy resolution to this stand-off since the fundamental interests of both camps diverge.

Members of the March 14th movement that dominates the cabinet see Syrian interests as the main problem: they argue that Syria needs Hizbollah's cabinet veto to prevent Lebanese cooperation over the UN tribunal into the Hariri assassination which looks set to implicate Syrian officials. March 14th also contend that Hizbollah is prepared to do Syria's bidding because it needs its support in order to retain its military strength and, consequently, domestic influence. For March 14th (whose name marks the date of the mass protest that eventually led to Syria's withdrawal from Lebanon), the matter is existential: an opposition veto risks derailing the UN tribunal and the start of the reassertion of Syrian power in Lebanon. Yet there is much at stake for the opposition too, even setting aside Syria. 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 redress the perceived injustice. Iran, which founded Hizbollah, also sees itself as benefiting from the group's empowerment, primarily to act as a counter-weight to Israel.

The tense and open-ended political dispute, punctuated by unexplained assassinations of prominent public figures and other violent incidents, undermines confidence and is a deterrent to investment. A prolonged stand-off, without a president or a functioning parliament, bodes poorly for the prospect of economic reform beyond minor administrative measures. Moreover, 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. Nonetheless, Gulf Arab states look likely to continue to support the Siniora government to counter Iran's influence in the broader region.

## Economic Prospects: Growth Remains Constrained

- The confidence-sensitive service sector that dominates the economy is suffering from the prolonged political turbulence.
- The government's large fiscal imbalances continue to crowd out private investment.
- GDP growth will remain constrained until the debilitating political stand-off is resolved.

**Table 2**

**Republic of Lebanon Economic And Financial Indicators**

| | 2010f | 2009f | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|---|---|---|---|---|---|---|
| Nominal GDP (bil. LB£) | 45,527 | 42,418 | 39,598 | 36,870 | 34,426 | 33,332 | 32,228 |
| Nominal GDP (bil. $) | 30 | 28 | 26 | 24 | 23 | 22 | 21 |
| GDP per capita ($000s) | 7.3 | 6.9 | 6.5 | 6.2 | 5.8 | 5.7 | 5.6 |
| Real GDP (% change) | 4.0 | 3.2 | 1.8 | 2.0 | (0.5) | 1.0 | 6.0 |
| Real GDP per capita (% change) | 2.5 | 1.7 | 0.5 | 0.5 | (1.8) | (0.6) | 4.6 |
| Real domestic demand (% change) | 4.7 | 3.7 | 1.8 | 1.9 | 0.1 | 1.6 | 5.4 |
| Real investment (% change) | 4.0 | 3.0 | 1.2 | 1.3 | (1.0) | 2.0 | 8.0 |
| Gross domestic investment (% of GDP) | 16.6 | 16.8 | 17.2 | 17.9 | 18.5 | 18.9 | 18.7 |
| Gross domestic savings (% of GDP) | 8.6 | 7.6 | 7.4 | 7.6 | 12.6 | 8.7 | (0.3) |
| Real exports (% change) | 5.5 | 5.0 | 5.5 | 6.0 | 13.0 | 3.0 | 10.0 |
| Consumer price index (% change) | 3.2 | 3.8 | 5.5 | 5.0 | 5.6 | 2.4 | 1.5 |
| Domestic credit to private sector and NFPEs (% change) | 7.0 | 5.8 | 4.0 | 2.2 | 5.7 | 1.3 | 4.7 |
| Domestic credit to private sector and NFPEs (% of GDP) | 70.5 | 70.7 | 71.6 | 74.0 | 77.5 | 75.7 | 77.3 |

NFPE--Nonfinancial public enterprise. f--Forecast. LB£--Lebanese pound.

### 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 75% of economic activity. This is followed in turn by industry, construction, and agriculture. Net income from abroad is substantial, reflecting transfers from Lebanese workers in the Gulf countries and from the sizeable Lebanese 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, the role of the large expatriate population in the domestic economy and, albeit to a lesser extent, the strong reputation that the long-established Lebanese banking system continues to enjoy within the region, together with the attraction of its secrecy laws.

The tourism sector, resurgent following the Israeli withdrawal from southern Lebanon in 2000 and the main engine of an upturn in construction activity, has suffered a series of knocks in recent years. These are the assassination of Hariri in early 2005, the conflict between Israel and Hizbollah in 2006, and the political tensions that have ensued. Recovery hinges on the abatement of security concerns. If political uncertainties ease, the medium-term outlook for the sector is robust, given the attractions of Lebanon as a tourist destination and the outlook for 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

Despite strong growth in the first half of 2006, output contracted slightly over the whole of the year, as the mid-year conflict harmed investor and consumer confidence and caused particular damage to the tourism and agriculture sectors, and as the subsequent Israeli blockade cut off capital goods and electricity. A hoped-for recovery in 2007 led by reconstruction and funded by donor inflows failed to materialize. Donor funds were slow to appear, tourists were deterred by political tensions, and business confidence remained subdued. Growth is estimated at 2% in 2007 and is not forecast to strengthen in 2008, barring a resolution to the difficult political stand-off.

## Fiscal Flexibility: Public Finances Remain Precarious

- The central government primary surplus of 3% of GDP was stronger than targeted under the IMF EPCA program.
- Funds pledged at the Paris-III donor conference of January 2007 have been slow to materialize, but there is a significant likelihood that Gulf Arab states will provide further fiscal support to the Siniora government.
- The central government deficit is forecast to remain above 9% of GDP in 2008, while fiscal flexibility will remain extremely limited, with interest payments accounting for almost 50% of revenues.
- Political uncertainty clouds the prospects for structural reform crucial for an overhaul of public finances.

**Table 3**

**Republic of Lebanon Fiscal Indicators**

| (% of GDP) | 2010f | 2009f | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|---|---|---|---|---|---|---|
| General government revenues | 27.5 | 27.4 | 27.8 | 27.3 | 24.9 | 25.7 | 26.9 |
| Of which central government | 24.3 | 24.1 | 24.5 | 23.7 | 21.2 | 22.2 | 23.3 |
| General government expenditures | 35.8 | 36.4 | 37.0 | 37.2 | 37.5 | 33.3 | 35.5 |
| Of which central government | 32.8 | 33.4 | 34.0 | 34.2 | 34.5 | 30.6 | 32.7 |
| General government balance | (8.3) | (9.0) | (9.2) | (9.9) | (12.6) | (7.6) | (8.6) |
| Of which central government | (8.5) | (9.3) | (9.5) | (10.4) | (13.3) | (8.4) | (9.4) |
| Of which local authorities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| General government primary balance | 2.8 | 2.3 | 2.4 | 2.1 | 0.7 | 3.0 | 3.9 |
| Central government primary balance | 3.0 | 2.4 | 2.5 | 3.0 | (0.1) | 2.2 | 3.1 |
| General government balance (% of revenues) | (30.3) | (32.9) | (32.9) | (36.2) | (50.4) | (29.7) | (31.8) |
| General government interest payments (% of revenues) | 40.5 | 41.3 | 41.6 | 44.1 | 53.1 | 41.3 | 46.3 |
| Central government interest payments (% of revenues) | 47.2 | 48.4 | 49.0 | 56.7 | 62.5 | 47.7 | 53.5 |
| Public sector gross debt | 152.7 | 154.9 | 156.3 | 158.1 | 170.0 | 174.0 | 160.0 |
| Of which general government debt | 152.7 | 154.9 | 156.3 | 158.1 | 170.0 | 166.7 | 153.2 |
| Of which central government debt | 164.0 | 166.9 | 168.8 | 171.1 | 177.1 | 174.0 | 160.0 |
| Public sector net debt | 144.6 | 146.2 | 147.0 | 148.0 | 157.1 | 157.2 | 146.5 |

**Table 3**

| **Republic of Lebanon Fiscal Indicators(cont.)** | | | | | | | |
|---|---|---|---|---|---|---|---|
| Of which general government net debt | 144.6 | 146.2 | 147.0 | 148.0 | 157.1 | 149.9 | 139.7 |
| Of which central government net debt | 155.9 | 158.2 | 159.5 | 161.1 | 164.2 | 157.2 | 146.5 |

f--Forecast.

## Expenditure, revenue, and balance performance

Lebanon registered a primary fiscal surplus equivalent to about 3% of GDP in 2007, surpassing by a significant margin the target set under the IMF's EPCA program. The outturn reflects stronger-than-expected tax receipts, the consequence of a slight upturn in economic activity and administrative reforms. Expenditure fell short of expectations because of delays to the capital spending program (the result of slower-than-expected donor inflows and political gridlock) and lower-than-expected transfers to Electricité du Liban (EDL). The significant possibility of further fiscal support from Gulf Arab countries marks another supporting factor. Gulf states, with Saudi Arabia at the fore, have deposited funds with the Banque du Liban (BdL) to shore up monetary stability and provided budgetary support funds.

Nonetheless, Lebanese public finances remain precarious. The government has estimated that the destruction and dislocation caused by the mid-2006 conflict between Hizbollah and Israel would add a cumulative $4.5 billion to the fiscal deficits over 2006-2010. While the central government deficit is forecast to narrow in 2008, from 10.4% in 2007 and 13.3% in 2006, it is expected to remain above 9% of GDP. Fiscal flexibility is deeply constrained by the huge debt stock, with interest payments expected to absorb almost 50% of revenues in 2008. Indeed, interest payments and personnel expenditure alone accounted for 97% of revenue in 2007.

As long as political difficulties persist, the authorities will have to contend with subdued economic growth and the prospect of higher interest rates to reflect increased risks. Moreover, donors have been slow to release funds pledged at Paris III. Countries supportive of the Siniora government (primarily the U.S., France, and Gulf Arab states) committed $7.6 billion in grants and concessionary loans to Lebanon, although less than $2 billion was initially pledged for direct budgetary support and some of the funds were made conditional on policy measures. Disbursal may accelerate in 2008 as administrative hurdles are overcome, but continued political uncertainties, and the consequent struggle to fulfill the package of reforms promised at Paris III, could yet delay the provision of funds. Indeed, while Lebanon's decision to request formal advice from the IMF, in the form of an EPCA program, provides an important anchor, the prospects for bold and far reaching reforms of the kind necessary to set public finances on a more sustainable path currently appear remote. The privatization of the two state-owned GSM licences, which would allow for a substantial reduction in the debt stock, has been postponed from February to May, for example, pending the formation of a national unity government.

## Government debt and interest burdens

The central government debt-to-GDP ratio narrowed to 171% of GDP in 2007, from 177% a year earlier, on the back of the primary surplus and debt reduction related to Paris III. Lebanese commercial banks are by far the largest creditor to the government, directly holding at least 55% of sovereign debt in addition to certificates of deposit with the central bank that enable the BdL to hold a further 14%. Much of the remaining debt is held by public entities (8%), primarily the National Social Security Fund, and in concessional loans and bonds by foreign donors (17%). The corollary of the government's reliance on the domestic banking sector is that the sovereign and central bank account for just over half commercial banks' assets.

This interdependence substantially reduces rollover risk: although the banks have threatened not to buy government debt unless the political crisis is resolved and the program of economic reform launched in earnest, they have continued to do so. The chief near-term default risk, rather, stems from the risk of capital flight from the banks that would undermine their capacity to lend to the government.

### Off-budget and contingent liabilities

The financial system represents the most significant contingent liability for the government. We estimate 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 just under 30% of GDP in 2007.

## Monetary Policy: Depositors' Resilience Tested

- The central bank has a relatively robust reserve position and a history of successful defense of the peg which has thus far mitigated the impact of political turbulence on the deposit base.
- Depositor confidence is shored up by a belief that donors, in particular rich Gulf states, will not allow the peg to break.
- Inflation has risen, driven by rising food and commodity prices and a falling pound, but is expected to ease from 2009.

Formally, the BdL's 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.

Depositors' confidence is critical to the banks' ability to finance the government and has proven remarkably resilient in the face of political shocks. An estimated $2 billion of deposits (3.5% of the total) left the country following the assassination of former prime Minister Rafik Hariri in February 2005 and the central bank lost about $1.5 billion defending the peg. The conflict between Hezbollah and Israel in mid-2006 prompted an outflow of $3 billion in deposits (5.4% of the total). However, despite a persistently high level of dollarization--76% as of August 2007--losses were recouped over time. Total deposits rose by almost 9% in 2007, or around 4% discounting retained earnings from interest, despite a worsening political situation.

Depositors' resilience stems from a number of factors. They tend to be dedicated, having ties to the country, as is the case with the large Diaspora. (Indeed, the size of capital inflows is not very significant relative to the pool of wealth that originates them.) Banking secrecy laws offer some appeal. The central bank has a strong reputation having successfully negotiated successive crises and boasts a relatively robust reserve position: including gold, usable reserves stood at an estimated $15.2 billion at year-end 2007, equivalent to 26% of M3 money supply--comprising cash and deposits, including foreign currency deposits--and 93% of M3 stripping out foreign currency deposits. Lebanon's record as having never defaulted also shores up confidence. Above all, confidence emanates from a belief that foreign donors will not allow the Lebanese financial system to fail. During the mid-2006 conflict, Saudi Arabia and Kuwait deposited $1.5 billion with the BdL; media reports in early 2008 indicated Saudi Arabia planned to deposit a further $1 billion.

Inflation remained relatively high in 2007, driven by rising global food and commodity prices and the weakening of the dollar-pegged Lebanese pound against the Euro. Inflation is expected to remain around 5% in 2008, but to decline thereafter unless domestic demand picks up more rapidly than currently seems likely.

## External Finances: Expatriate Gulf Funding Will Be Crucial

- The current account deficit is expected to remain wide, at around 10% of GDP in 2008 as tourism continues to suffer.
- Nonresident deposits and other recurrent capital inflows are vital to provide coverage of the large external gap.
- The public sector has net external assets estimated at 58% of CARs, as foreign currency-denominated government debt is largely held by domestic investors.

**Table 4**

**Republic of Lebanon External Indicators**

| | 2010f | 2009f | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|---|---|---|---|---|---|---|
| **(% of GDP)** | | | | | | | |
| Current account balance | (8.0) | (9.2) | (9.8) | (10.2) | (5.9) | (10.3) | (19.1) |
| Trade balance | (26.5) | (25.7) | (25.2) | (25.2) | (25.2) | (27.7) | (30.2) |
| Net foreign direct investment | 9.0 | 9.0 | 8.0 | 7.0 | 11.9 | 11.9 | 8.3 |
| **(% of CARs)** | | | | | | | |
| Current account balance | (9.7) | (11.0) | (11.7) | (12.2) | (6.2) | (11.8) | (22.5) |
| Net external liabilities | 35.2 | 33.1 | 31.8 | 32.3 | 42.6 | 74.7 | 73.4 |
| Total external debt | 126.1 | 127.7 | 132.0 | 133.1 | 114.8 | 126.5 | 140.8 |
| General government external debt | 41.7 | 43.1 | 45.3 | 45.4 | 34.9 | 39.2 | 40.1 |
| Narrow net external debt¶ | (73.7) | (71.9) | (71.3) | (71.2) | (50.0) | (28.7) | (20.8) |
| Net public sector external debt | (52.5) | (53.5) | (55.5) | (57.8) | (53.4) | (46.5) | (46.0) |
| Net nonbank private sector external debt | (47.4) | (46.4) | (45.8) | (43.5) | (39.0) | (27.9) | (20.9) |
| Net banking sector external debt | (34.2) | (31.4) | (29.2) | (26.7) | (10.9) | 1.6 | 5.3 |
| Net investment payments | (1.7) | (1.0) | (1.6) | (1.0) | (1.0) | 0.9 | 4.5 |
| Net interest payments | (0.5) | (0.5) | (1.0) | (1.5) | (1.1) | (0.7) | 2.4 |
| Reserves/CAPs (months) | 6.9 | 7.2 | 7.4 | 7.1 | 6.1 | 6.3 | 6.8 |
| Gross external financing needs (% of CARs and usable reserves) | 115.8 | 115.5 | 115.8 | 118.4 | 119.3 | 131.4 | 118.5 |

¶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.

### 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 25% of GDP in 2007. The huge trade deficit is typically partially offset by transfers and services surpluses. The current account is expected to register a deficit of around 10% of GDP in 2008, little changed from 2007. Tourism inflows are likely to decline further but this will be partly offset by subdued demand for imports and a pick up in official transfers released under Paris III.

In different circumstances, Lebanon would likely receive substantial direct and portfolio equity investment, driven by Gulf Arab countries that are set to continue to generate large current account surpluses on the back of high oil prices and strong production. However, inflows will remain sensitive to political developments. Political tensions are also likely to impede efforts to advance large-scale privatization. Non-equity capital inflows will therefore remain vital. These comprise mostly the banking deposits of nonresident Lebanese and Gulf investors. While the resilience of these depositors is well-documented, a breakdown of political order would probably have a severe impact on confidence. There is a strong possibility that Gulf Arab states will, nonetheless, continue to furnish direct foreign currency liquidity.

### Narrow net external debt

In 2007, Lebanon registered a narrow net external asset position equivalent to an estimated 71% of CARs. Total public sector external debt is forecast at 46% of CARs at year-end 2007. In net terms, public sector assets are forecast at 58% of CARs in 2007. A little over one-half of the government debt is denominated in U.S. dollars, but nonresident holdings of Eurobonds are estimated to be low, at less than 10% of the total. Net external assets of the banking sector rose to an estimated 27% of CARs in 2007 from 11% in 2006. 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 an external creditor. Estimates derived from Bank for International Settlements statistics point to net external nonbank private sector assets of 44% of CARs in 2007.

| **Ratings Detail** (As Of February 28, 2008)* | |
|---|---|
| **Lebanon (Republic of)** | |
| Sovereign Credit Rating | CCC+/Stable/C |
| Senior Unsecured | CCC+ |
| Short-Term Debt | |
| *Local Currency* | C |
| **Sovereign Credit Ratings History** | |
| 31-Jan-2008 | CCC+/Stable/C |
| 25-Nov-2007 | B-/Watch Neg/C |
| 11-Sep-2006 | B-/Negative/C |
| 13-Jul-2006 | B-/Watch Neg/C |
| 10-Oct-2003 | B-/Stable/C |
| 24-Apr-2003 | B-/Positive/C |
| **Default History** | |
| None | |
| **Population** | 3.97 million (2007) |
| **Per Capita GDP** | $6,160 (2007) |
| **Current Government** | |
| Parliament is yet to form a consensus on who should succeed Emile Lahoud, who stood down as president after completing an extended term in office in November 2007. The president, who is the head of state, together with the prime minister, currently Fouad Siniora, and parliamentary speaker Nabih Berri, compose Lebanon's triumvirate of leaders. | |

**Ratings Detail** (As Of February 28, 2008)***(cont.)**

**Election Schedule**

Presidential
Last........November 1998
Next........Initially due November 2007, but has been repeatedly postponed
Parliamentary
Last......May 2005
Next......May 2009

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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