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Analysis

LEBANON
Europe/M.East/Africa

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Contact	Phone
London	
Tristan Cooper	44.20.7772.5454
New York	
Joan Feldbaum-Vidra	1.212.553.1653
Vincent J. Truglia	

Lebanon

Macroeconomic Performance

The Lebanese economy has been adversely affected by the political upheaval following the assassination in February 2005 of the former prime minister, Rafiq al-Hariri. Detailed analysis of the real sector is hampered by a lack of data. However, it is estimated that real GDP growth slowed to below 1% in 2005 following growth of around 6% in 2004, the highest rate of growth since 1995. Both the domestic and external sectors of the economy have suffered. Consumption and investment have faltered while services exports have been hit by a fall in tourist arrivals. The Lebanese economy remains concentrated in services, which are estimated to account for around 60% of total output. Owing to a lack of primary commodities and limited manufacturing capacity, the country's export base is narrow, with goods exports composing only around 8% of GDP.

The outlook for growth is clearly dependent on the political environment, which remains highly uncertain. However, the Lebanese economy has proven remarkably resilient during previous periods of instability and has the potential to perform strongly. Lebanon benefits from a well-educated workforce, a large and committed diaspora, a sophisticated financial system, an attractive climate and geography, and a currently high level of regional liquidity. Yet it also faces several economic obstacles, the foremost of which is the massive public debt burden, mostly accumulated during reconstruction following the end of the fifteen year civil war in 1990. The huge servicing requirement of this debt results in a wide fiscal deficit, which constrains productive public expenditure, inflates domestic interest rates, and diverts private savings.

Although it is likely that the government will again be able to attract foreign financial support in order to relieve its debt burden over the short term, significant fiscal and other structural adjustments will likely be needed if the debt trajectory is to be reversed onto a downward path over the longer term. The present government is keenly aware of this and has drawn up a comprehensive programme of economic reforms. However, the implementation of this programme will be difficult without political consensus, which will be hard to muster given Lebanon's fractious domestic politics. Additional impediments to growth include the high cost of telecommunications, an ageing infrastructure, a moderately high level of corruption, and an often cumbersome bureaucracy. Nevertheless, Lebanon has a more liberal business environment than many other similarly rated countries.

Political/Social Developments

The political environment in Lebanon remains precarious. It is unclear whether the new government, formed by Prime Minister Fouad Siniora in July 2005, will be able to achieve and sustain the necessary political consensus to govern effectively. The challenge of preserving unity in the face of ingrained political and sectarian divisions was illustrated in December 2005, when five pro-Syrian Shiite ministers suspended their participation in the cabinet. Although an anti-Syrian alliance of mainly Sunni and Druze leaders have a majority in the cabinet and the parliament following elections in mid-2005, it will be difficult for this alliance to push through policy against the wishes of opposing factions, particularly the pro-Syrian Shiite Hezbollah and Amal parties, which represent a sizeable segment of the population.

The most divisive political issues facing Lebanon are its relations with Syria, UN Security Council Resolution 1559 (which among other things calls for the disarming of Hezbollah), and the issue of who will replace President Lahoud. Lebanon's relations with Syria remain tense following the withdrawal of Syrian troops from Lebanon in April 2005 and they continue to be complicated by the ongoing UN investigation into Hariri's assassination. The potential for disruption caused by a breakdown in the relationship with Syria was evident in July 2005, when Syria temporarily closed its border to Lebanese trucks, leading to a sharp fall in Lebanese exports that month (Syria is Lebanon's main export destination). Furthermore, there is widespread suspicion that the Syrian authorities have been involved in a series of destabilising assassinations of prominent anti-Syrian figures in Lebanon since Hariri's death.

The Lebanese government has so far resisted demands by the US and other western countries that it disarm Hezbollah, in line with Resolution 1559. This is largely because Hezbollah is a powerful political entity, which retains widespread support in the predominately Shiite south of the country as well as backing from both Syria and Iran. While the US is aware of the domestic political sensitivity of such an action, it will likely continue to put pressure on the Lebanese government to comply with this resolution. This will serve as an additional source of friction between Lebanon's political parties.

Meanwhile, Lebanese Christians feel unnerved by the waning authority of the president, who must be a Christian according to constitutional custom. President Lahoud, who continues to have close relations with Syria, has lost legitimacy and power since the extension of his term for a further three years in September 2004 and the recent parliamentary victory of an anti-Syrian coalition. It is unclear whether or not the president will remain in office until the end of his term in 2007, as is the issue of who will replace him. President Lahoud retains, however, the ability to disrupt the functioning of government, including through the withdrawal of loyal ministers and the delaying of legislation.

Government Finance and Debt

Despite narrowing considerably since 2000, the overall fiscal deficit remains wide, at an estimated 7.9% of GDP in 2005. The root cause of the deficit remains the large public debt service burden. Interest payments are estimated to have consumed around 46% of government revenues in 2005 (the highest level of any rated country) and accounted for around 10.5% of GDP. Hence the fiscal account remained deeply in the red last year despite the maintenance of a primary surplus of around 2.6% of GDP. The primary surplus would have been higher had it not been for a large increase in transfers to the state-owned electricity firm, Electricite Du Liban (EDL). This increase was due to poor management and soaring international oil prices - Lebanon imports virtually all of its energy needs.

Further improvement of the primary balance rests on the ability of the government to pass and implement its ambitious agenda of economic reforms, which is currently being finalized in the form of a draft budget for 2006 and a new five-year economic programme. The key features of this agenda are likely to be an increase in the rate of value added tax, an increase in the rate of tax on interest income, the uncapping of gasoline prices, and the containment of the public sector wage bill. Furthermore, the government is keen to close two social spending funds (the Council for the South and the Fund for Displaced), restructure EDL and kick-start privatization, initially focusing on the sale of the government's mobile telecoms assets. However, there is a risk that the programme could be subject to revisions and implementation delays in the face of political opposition. It is notable that a less ambitious programme of economic reforms presented at the Paris II donors' conference in November 2002 remains largely unimplemented.

Lebanon's public debt burden is one of the highest in the world in relation to GDP and government revenue. We estimate that Lebanon's gross general government debt stock climbed to 166% of GDP at end-2005, the highest level of any rated country except Japan. In relation to government revenue, the debt stock amounted to an estimated 727%, by far the highest level of any rated sovereign. The major factor explaining the country's ability to withstand such a high level of debt (the government has never defaulted) is the large and growing size of the domestic banking system, which is the primary source of financing for the government.

Lebanon's ratio of government debt to M3 has remained relatively steady over the past seven years at around 74%, a moderate level and similar to that of Morocco or Qatar. However, the elevated level of M3 in Lebanon is potentially volatile and a prolonged stagnation or decline in bank deposits would swiftly lead to refinancing pressures for the government, as witnessed during the first half of 2002. Commercial banks' balance sheets are already saturated with public sector debt (around 55% of total bank assets are invested either with the Lebanese government or central bank). Although it should be noted that bank depositors (most of whom are resident and non-resident Lebanese) have proven highly resilient in the past, including during recent political events. The level of bank deposits recovered quickly after dipping in the wake of Hariri's assassination.

The structure of the government's debt stock has improved significantly since the 2002 Paris II donors' conference. The government used concessional loans from donors to repurchase more expensive market debt. This led to a fall in the proportion of the government's debt that is marketable from around 80% prior to Paris II to around 60% today. Furthermore, local banks agreed to exchange cash or outstanding government debt for zero interest paper. These developments contributed to a marked decline in domestic interest rates and a significant easing of the government's debt servicing requirement.

However, local interest rates have begun to rise again since Hariri's assassination and, given the fixed exchange rate peg to the US dollar, further upward pressure is likely to be exerted by the ongoing tightening of monetary policy by the Federal Reserve. Hence, in the absence of further inflows of foreign financial assistance or substantive fiscal reform and privatization, the government's debt servicing bill and debt stock are likely to rise gradually over the medium term. Furthermore, with around 52% of the government's debt stock denominated in foreign currencies, any unexpected change in the exchange rate could have a profound effect on the level of government debt in local currency terms.

Peer Comparisons

Lebanon's main government finance and debt ratios generally under perform those of its peers in the B1 to C rating group (for details of this rating group, please see Moody's Statistical Handbook, Country Credit, November 2005). Lebanon's general government deficit is expected to average 8.7% of GDP between 2004 and 2006, the highest deficit in the peer group, whose median deficit is expected to average 2.7% of GDP during this period. Lebanon's gross general government debt to GDP ratio is expected to average 164.6% between 2004 and 2006, which is again the highest level in the peer group, whose median debt to GDP ratio is expected to average 62.4%. Meanwhile, Lebanon's gross general government debt to revenue ratio is expected to average 715.8%, the highest level in the rating group and considerably greater than the average median for the group of 254.7%. However, as mentioned above, Lebanon's gross general government debt to M3 ratio is lower than that of most of its peers. Lebanon's ratio stood at 72.9% at end-2004, compared to a median for the rating category of 129.2%.

External Vulnerability and Liquidity

Lebanon's external liquidity remains relatively robust, despite the maintenance of a wide current account deficit. Although the authorities do not publish comprehensive data for the balance of payments, we estimate that the current account deficit widened to around 17.2% of GDP in 2005, close to its five year average of 15.8%. The current account is structurally weak owing to the country's narrow export base and heavy external debt servicing requirement. The deficit continues to be financed largely through foreign direct investment and, increasingly, more liquid inflows of non-resident bank deposits and portfolio investment.

It is difficult to calculate the exact level of external debt, largely because there are no official estimates of the amount of government debt held by non-residents. However, on the assumption that around 23% of the government's debt is held by non-resident entities (mostly in the form of Eurobonds), we estimate that Lebanon's total gross external debt amounted to around 106% of GDP at end-2005, a very high level. Although it should be noted that around half of the country's external debt is accounted for by the foreign liabilities of the commercial banks, which are offset by foreign assets (the commercial banking system is a net foreign creditor).

The central bank's gross foreign currency reserves stood at $9.5 billion at end-October 2005 (an estimated 43% of GDP). This was enough to cover a healthy 8.5 months of estimated imports of goods, services and income or 60% of the domestic currency money supply (M3 less foreign currency deposits). This means that reserves would be sufficient to cover an approximate 20% increase in the rate of dollarization of M3, which at end-October stood at around 67%. The rate of dollarization in Lebanon is volatile, however. This was witnessed recently in the aftermath of Hariri's assassination, when the level of dollarization increased from 63% at end-January 2005 to 74% at end-March. This contributed to a significant drop in official foreign currency reserves, although the level of reserves has since recovered as dollarization has eased. In addition to its foreign currency reserves, the central bank also holds a substantial amount of gold (worth $4.4 billion at end-October 2005). However, the liquidity of the gold is limited by national law, which prohibits the sale of gold without prior parliamentary legislation.

Peer Comparisons

As with its government finance and debt indicators, Lebanon's main external indicators generally under perform those of its peers in the B1 to C rating group. Lebanon's external current account deficit is expected to average 16.9% of GDP between 2004 and 2006, compared with an average median deficit for the peer group of 0.8% of GDP. Only Bosnia Herzegovina (B3) and Nicaragua (Caa1) have higher average current account deficits during this period. Lebanon's external debt to GDP ratio is the highest in the B1 to C rating group, while only Argentina (B3) and Uruguay (B3) have higher average external debt to current account receipt ratios between 2004 and 2006. Although, as mentioned above, a significant portion of Lebanon's external debt comprises non-resident deposits and other commercial bank foreign liabilities which are matched by foreign assets.

Rating History

Rating History: Lebanon

		Country Ceilings for Foreign Currency			
		Bonds & Notes		Bank Deposits	
Date	Action	Long-term	Short-term	Long-term	Short-term
26 February-97	Rating Assigned	B1	NP	--	--
6 May-97	Rating Assigned	--	--	B2	NP
30 July-01	Rating Lowered	B2	--	--	--
24 March-05	Rating Lowered	B3	--	B3	--

Related Research

Country Credit Statistical Handbook:

Moody's Country Credit Statistical Handbook - November 2005, (94977)

Banking System Outlook:

Lebanon, February 2005 (91436)

Special Comment:

Moody's Sovereign Ratings: A Ratings Guide, March 1999 (43788)

A Quantitative Model for Local Currency Government Bond Ratings, September 2003 (79404)

A Quantitative Model for Foreign Currency Government Bond Ratings, February, 2004 (81176)

Revised Country Ceiling Policy, June 2001 (67679)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Lebanon

	1998	1999	2000	2001	2002	2003	2004	2005E	2006F	2007F
Economic Structure and Performance										
Nominal GDP (US$ Bil.)	16.91	17.01	16.68	17.07	18.46	19.63	21.39	21.93	23.02	24.40
Population (Mil.)	4.21	4.27	4.33	4.38	4.44	4.50	4.55	4.61	4.67	4.73
GDP per capita (US$)	4016	3982	3854	3892	4157	4363	4697	4753	4927	5155
GDP per capita (PPP basis, US$)	4136	4104	4162	4353	4650	5034	5320	5567	-	-
Nominal GDP (% change, local currency)	6.8	0.0	-2.0	2.3	8.2	6.3	9.0	2.5	5.0	6.0
Real GDP (% change, local currency)	3.0	-0.8	0.9	4.4	2.6	5.0	6.0	0.5	3.0	4.0
Inflation Rate (CPI, % change, eop)	2.4	-0.1	-0.4	0.7	1.6	2.2	2.5	2.0	2.0	2.0
Gross Investment/GDP (%)	29.0	23.1	20.3	23.0	18.4	18.9	20.4	18.9	19.1	19.3
Gross Domestic Saving/GDP (%)	0.2	-1.1	-3.2	-2.9	-1.9	-1.6	-4.6	-6.5	-5.9	-5.4
Nominal Exports of G & S (% change, US$ basis)	4.9	7.3	10.8	5.0	20.6	14.8	19.4	-7.4	7.6	7.8
Nominal Imports of G & S (% change, US$ basis)	-0.1	-7.6	-1.4	14.7	-6.4	10.6	27.1	-1.0	5.0	6.0
Openness of the Economy (%) [1]	26.4	28.2	31.8	32.7	36.5	39.4	43.1	38.9	39.9	40.6
Government Finance										
Gen. Gov. Revenue/GDP (%)	17.4	19.0	19.0	18.1	20.9	22.5	23.3	22.9	22.9	22.9
Gen. Gov. Expenditures/GDP (%)	30.8	33.0	42.2	34.5	36.4	35.8	32.7	30.8	31.7	32.4
Gen. Gov. Financial Balance/GDP (%)	-13.5	-14.0	-23.3	-16.4	-15.5	-13.3	-9.4	-7.9	-8.9	-9.5
Gen. Gov. Primary Balance/GDP (%)	-0.4	0.2	-6.6	0.3	1.1	3.2	3.1	2.6	2.6	2.6
Gen. Gov. Direct Debt/GDP (%)	102.1	122.9	140.2	153.9	158.3	161.3	160.8	166.0	167.0	167.1
Gen. Gov. Direct Debt/Gen. Gov. Revenue (%)	588.2	646.8	739.4	851.6	755.7	717.2	690.2	726.5	730.8	731.1
Gen. Gov. Int. Pymt/Gen. Gov. Revenue (%)	75.3	74.4	88.0	92.8	79.3	73.2	53.5	46.0	50.2	53.0
Gen. Gov. FC & FC-indexed Debt/Gen. Gov. Debt (%)	24.1	26.4	30.7	36.5	49.9	49.1	53.4	52.3	52.3	52.3
Gen. Gov. Direct Debt (US$ Bil.)	17.35	20.91	23.39	26.26	29.22	31.66	34.40	36.41	38.46	40.78
GG Direct Debt Owed to Non-residents/GG Direct Debt (%)	14.7	19.1	16.9	14.6	18.6	23.1	23.1	23.1	23.1	23.1
External Payments and Debt										
Current Account Balance (US$ Bil.)	-4.40	-3.32	-2.84	-3.59	-2.38	-2.36	-3.42	-3.76	-4.06	-4.15
Current Account Balance/GDP (%)	-26.0	-19.5	-17.0	-21.0	-12.9	-12.0	-16.0	-17.2	-17.6	-17.0
External Debt (US$ Bil.)	10.77	13.28	13.96	14.88	15.36	20.02	23.69	23.32	24.53	26.07
External Debt/GDP (%)	63.7	78.1	83.7	87.2	83.2	102.0	110.7	106.4	106.5	106.8
External Debt/CA Receipts (%) [2]	203.0	230.1	220.4	224.2	200.1	225.7	226.3	230.1	231.7	230.6
Net Foreign Direct Investment/GDP (%)	7.7	8.2	6.2	8.9	9.6	10.4	10.5	6.8	7.4	7.8
Official Forex Reserves (US$ Bil.)	6.40	7.60	5.75	4.36	5.07	10.20	9.49	9.81	9.81	9.81
Nominal Exchange Rate (local currency/US$; eop)	1508	1508	1508	1508	1508	1508	1508	1508	1508	1508
Short-term External Debt/Total External Debt (%)	54.8	48.1	51.5	49.4	47.9	46.6	51.1	48.3	48.9	49.9
Interest Paid on External Debt (US$ Bil.)	0.57	0.75	0.80	0.72	0.63	0.64	0.72	0.85	0.91	0.96
Amortization Paid on External Debt (US$ Bil.)	0.99	1.12	1.18	1.25	1.36	1.60	1.78	1.99	2.19	2.40
Net Foreign Assets of Domestic Banks (US$ Bil.)	0.71	-0.48	0.97	1.27	2.14	0.58	1.46	2.15	-	-
Monetary, Vulnerability and Liquidity Indicators										
Domestic Credit (% change, eop)	24.8	12.3	15.2	11.6	0.8	5.0	9.0	3.0	-	-
Domestic Credit/GDP (%)	137.4	154.2	181.3	197.7	184.3	182.1	182.1	183.1	-	-
M3/Official Forex Reserves (X)	4.2	3.9	5.7	8.0	7.5	4.2	5.0	5.0	-	-
Debt Service Ratio (%) [3]	29.5	32.4	31.3	29.6	26.0	25.2	23.9	28.0	29.3	29.7
External Vulnerability Indicator (%) [4]	92.3	84.2	125.1	168.5	145.2	91.5	127.4	114.9	122.4	132.6
Liquidity Ratio (%) [5]	12.8	16.0	14.7	21.0	13.3	12.6	15.0	14.1	-	-
"Dollarization" Ratio (%) [6]	60.6	56.6	62.2	69.0	65.6	60.9	64.9	68.4	-	-
"Dollarization" Vulnerability Indicator (%) [7]	120.1	120.7	141.9	183.3	166.6	126.7	130.0	138.1	-	-
M3 (% change, eop)	16.1	11.7	9.8	7.5	8.1	13.0	10.1	4.7	-	-
Short-Term Nominal Interest Rate (%, eop)	16.7	14.6	14.6	14.6	9.4	8.0	7.9	8.7	-	-
Total External Debt/Forex Reserves (%)	168.3	174.9	242.9	341.1	302.9	196.3	249.5	237.8	250.1	265.8
Total Liabilities due BIS Banks/Total Assets Held in BIS Banks (%)	21.9	22.9	19.9	17.1	14.9	16.5	20.8	21.0	-	-

Notes:
[1] Sum of Exports and Imports of Goods and Services/GDP (%)
[2] Current Account Receipts
[3] (Interest + Current-Year Repayment of Principal)/Current Account Receipts (%)
[4] (Short-Term External Debt + Currently Maturing Long-Term External Debt)/Official Foreign Exchange Reserves (%)
[5] Liabilities to BIS Banks Falling Due Within One Year/Total Assets Held in BIS Banks (%)
[6] Total Foreign Currency Deposits in the Domestic Banking System/Total Deposits in the Domestic Banking System (%)
[7] Total Foreign Currency Deposits in the Domestic Banking System/(Official Foreign Exchanges Reserves + Foreign Assets of Domestic Banks) (%)

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Author

Tristan Cooper

Production Associate

David Ainsworth

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