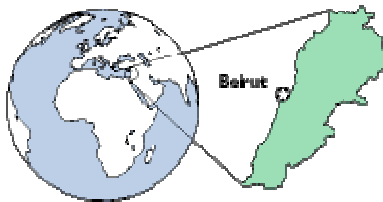


# COUNTRY REVIEW

## Lebanon Update



26 October 2009

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**EULER HERMES COUNTRY RISK GRADE: D**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.

## ECONOMIC STRUCTURE

### Country Profile

Capital city:	Beirut
Population:	4.19 mn (2008)
GDP:	USD 27761 mn (2008)
Currency:	Pound (LBP)
Form of state:	Republic
Head of government:	PM Saad Hariri (yet to be confirmed)
Next elections:	Parliamentary by June 2013

Major Industries (% of GDP at market prices, 2008e)		Global Assumptions		2009f	2010f
Agriculture	5.0%	Real GDP grth (% yr/yr) *	-3.9		0.9
Industry	19.0%	Inflation (% av) *	-0.1		1.3
Services	76.0%	Dated Brent (USD/b)	61		72
* major economies					

Main Exports (% of total, 2008e)		Main Imports (% of total, 2008e)	
Precious stones & gems & jewellery	24.0%	Mineral (including fuels)	26.0%
Machinery	14.0%	Machinery	12.0%
Foodstuffs	8.0%	Transport Equipment	8.0%
Chemicals	7.0%	Chemicals	7.0%
Lead Export Markets (% of total exports, 2007)		Lead Import Markets (% of total imports, 2007)	
Syria	25.2%	Syria	12.1%
UAE	11.8%	Italy	8.5%
Switzerland	8.1%	France	8.3%
Saudi Arabia	5.6%	US	7.0%

## Basic indicators

Selected economic indicators	2006	2007	2008	2009f	2010f
Nominal GDP (USD mn)	22,704	24,600	27,761	30,166	32,040
Population (mn)	4.13	4.16	4.19	4.22	4.25
GDP per capita (USD)	5,497	5,914	6,626	7,148	7,539
Real GDP growth (% yr/yr)	-4.0	4.0	7.0	3.5	5.0
Inflation (% average)	2.5	6.0	10.0	1.5	4.0
Fiscal balance (% of GDP)	-13.3	-10.3	-10.7	-11.4	-10.5
Current account balance (% of GDP)	-5.5	-5.4	-11.0	-9.4	-9.1
External debt/GDP (%)	105.6	100.1	92.8	88.4	87.1
External debt/Exports of goods & services (%)	107.7	97.0	78.5	91.5	87.2
Debt-service ratio (%)	19.9	17.9	16.8	20.6	15.6
Foreign exchange reserves (USD mn)	13,313	12,844	20,182	24,500	24,000
Import cover (months)	6.8	5.8	6.8	9.2	8.3
Exchange rate assumption, LBP:USD (av)	1,507.5	1,507.5	1,507.5	1,507.5	1,507.5
f: CRU central forecast					

Sources: Central Bank, IMF, World Bank, Euler Hermes Country Risk Unit

## Political Stability

In June 2009 parliamentary elections, the March 14<sup>th</sup> movement (largely pro-west) won a majority of seats. However, since then the Prime Minister-designate, Saad Hariri, has been **struggling to form a government of national unity**. The opposition coalition, the March 8<sup>th</sup> alliance of Hezbollah, Amal and some Christian factions, has not accepted cabinet allocations for its followers suggested by Hariri. Accordingly, the **political environment remains uncertain and tense**. In the meantime, Lebanon is undergoing a further **period without an effectively-functioning government**.

**Regional relations also remain tense**, with missiles fired into northern Israel in September and continuing reports of Hezbollah re-arming. There is a high risk of another confrontation with Israel, particularly if the latter is restricted from a pre-emptive strike against Iran, which is perceived as a principal backer of Hezbollah and is accused of trying to establish its own nuclear armaments. A strike directly on Iranian nuclear facilities by either Israel or the US would probably lead to armed insurrection by Hezbollah within Lebanon and/or against Israel. To that extent, a **return to outright civil war in Lebanon cannot be discounted**.

## Economic Stability

**GDP Growth:** Against a global economic slowdown and, in particular, a weaker regional (GCC) business environment, GDP growth in Lebanon will be restricted to around 3.5% in 2009 and 5% in 2010 (subject to there not being armed conflict). Weaker oil prices through H1 2009, tightening liquidity and general risk aversion reduced the pace of inward investment, increased capital repatriation and stalled some infrastructure projects.

**Inflation:** Consumer price inflation in 2008 was driven upwards by high oil and other commodity prices through most of the year and averaged 10%. However, imported inflationary pressures eased this year as the global slowdown resulted in reductions in commodity prices (evident from Q4 2008). We forecast average consumer price inflation at only 1.5% in 2009, rising to 4% in 2010.

**Policy:** As formation of a government of national unity is proving very difficult, economic reforms are largely on hold. The June polls merely re-affirmed the deep political/sectarian divides in the country and suggest that effective governance and reform implementation will be largely absent this year and probably highly limited in 2010. This makes it difficult to arrive at a domestic consensus on how to address Lebanon's long-term structural fiscal deficit, which derives largely from the costs of servicing public debt, which is estimated at 160% of GDP. In practice, cuts in government expenditure to improve the budgetary position appear unlikely.

The central bank is committed to defend the pound's peg to the USD within a trading band of USD1=LBP1,501-1,514 and it uses monetary policy (influence on domestic interest rates), relatively high levels of FX reserves and strong support from the local banks to achieve this target. However, the country's large fiscal and current account deficits indicate a longer-term vulnerability for the exchange rate. Adverse international sentiment could again reduce FX reserves and this would require further support from GCC states and, ultimately, the IFIs.

**External Balance:** A large deficit in the merchandise trade balance is offset partially by a positive net balance on services, incomes and transfers. However, we expect large annual current account deficits (equivalent to 5-14% of GDP since 2005) to continue into 2010, although some improvement is expected next year because the economic downturn has curbed some spending on consumer imports and lower oil and commodity prices have reduced the import bill relative to 2008. The global economic downturn exerted a negative influence through a decline in net transfers as international financial assistance and remittances (there are more Lebanese domiciled overseas than in the country itself) both recorded declines. Overall, we forecast the current account deficit in 2009 will be equivalent to over 11% of GDP, with only a moderate improvement to 10.5% in 2010.

Financing current account deficits of such magnitude (together with foreign debt repayments) has been possible since 2005 because of large net inflows of portfolio and direct investments, in addition to accumulation of further debt obligations. Although we expect portfolio and FDI inflows will be down this year and in 2010, the financing gaps are likely to be bridged without undue financial stress—as long as regional oil states remain supportive. Despite evidence that even the GCC states are experiencing liquidity constraints and economic slowdowns, it is unlikely that they will not come to Lebanon's assistance, in need.

## Summary & Conclusion

The country was pulled back from sliding into a renewed civil war when an agreement between rival political factions was signed at Doha in Qatar in May 2008. This offered the prospect of resolution of at least some long-standing issues. However, sectarian divides have yet to be bridged and, although there is a signed declaration of political power-sharing, **a government of national unity under PM-designate Saad Hariri is yet to be formed**. Hariri's 14<sup>th</sup> March movement won a majority of parliamentary seats in elections in June 2009. The rival sides do not find it easy to agree mutually-acceptable policies and implementation is far from automatic, given the strength of obstruction in power groups. Economic reforms (privatisation, cutting budget spending etc.), which had been put on hold until political stability could be established, have similarly had to confront competing demands from the various factions trying to establish a government. **There remain serious downside risks to the political and security environments.**

More positively, international funding (through Lebanese in the diaspora and the GCC states) has been made available. Nevertheless, the domestic political and regional perspectives will remain tense and, until a track record of improved security can be established, Lebanon will remain an economy to be monitored closely for any further signs of deterioration in trading conditions.

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## Charts

