Rabobank

Country report **LEBANON**

Summary

The largest country risks in Lebanon lie in the political sphere, as the conflicts between the coalition party and main opposition party are fierce and hinder any progress on economic reforms. The fiscal position is very weak and the outlook is negative as the government has not made a final budget yet for 2012. While the current account posts substantial deficits due to high imports, these are sufficiently covered by capital inflows. Furthermore, these capital inflows have resulted in a high level of FX-reserves, which covers 13 months of imports, a sound level. The economy is estimated to have grown only 2% in 2011, as domestic activity has cooled. The economic outlook is bleak as the regional unrest, particularly in Syria, will weigh on economic activity.

Things to watch:

- Domestic political situation
- The deteriorating fiscal position
- Developments of regional social unrest, particularly in Syria

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Lebanon

National facts	
Type of government	Constitutional republic
Capital	Beirut
Surface area (thousand sq km)	10.4
Population (millions)	4.2
Main languages	Arabic (official)
	French
Main religions	Muslim (60%)
	Christian (39%)
	Other (1%)
Head of State (president)	Michel Sulayman
Head of Government (PM)	Najib Mikati
Monetary unit	Lebanese pounds (LBP)

Economy		2010
Economic size	*bn USD*	*% world total*
Nominal GDP	36	0.06
Nominal GDP at PPP	59	0.08
Export value of goods and services	24	0.14
IMF quotum (in mln SDR)	203	0.09
Economic structure	*2010*	*5-year av.*
Real GDP growth	7.2	5.1
Agriculture (% of GDP)	5	6
Industry (% of GDP)	16	18
Services (% of GDP)	79	77
Standards of living	*USD*	*% world av.*
Nominal GDP per head	8403	86
Nominal GDP per head at PPP	13960	121
Real GDP per head	6950	88

Social and governance indicators	rank / total
Human Development Index (rank)	62 / 187
Ease of doing business (rank)	104 / 183
Economic freedom index (rank)	89 / 179
Corruption perceptions index (rank)	134 / 183
Press freedom index (rank)	78 / 178
Gini index (income distribution)	n.a.
Population below $1 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Syria	25	Syria	11
UAE	15	Italy	10
Switzerland	7	US	9
Saudi Arabia	6	France	7
Main export products (%)			
Precious stones & jewellery			23
Machinery & mechanical equipment			17
Chemicals			10
Prepared foodstuffs			7
Main import products (%)			
Mineral products			19
Machinery & mechanical goods			12
Transport equipment			10
Chemical products			9
Openness of the economy			
Export value of G&S (% of GDP)			67
Import value of G&S (% of GDP)			92
Inward FDI (% of GDP)			15.4

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

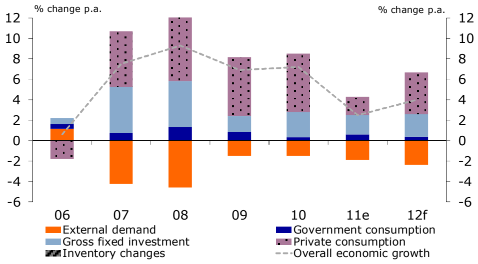
Economic structure and growth

The Lebanese economy boomed in the recent past, even in a period of regional political and social instability and an extremely difficult global economic environment, but slumped during 2011. GDP was expanding at an annual average rate of 7.7% in real terms over the last four years up to 2011, beating all countries in the region except for Qatar. Nominal GDP per capita of USD 8,403 is low to moderate but pales in comparison to that of its oil exporting neighbours. However, adding the sizeable extra-territorial economy (remittances from Lebanese abroad amount to 20% of GDP) to domestic economic activity and correcting for different price levels leads to a Gross National Income per capita of around USD 24,000, which equals that of Chile and Turkey, which is more than double that of Egypt, Jordan and Syria, but is still only half of the Israel's GNI per capita (in PPP terms). Economic activity is concentrated in the Greater Beirut area, which accounts for three-quarters of GDP.

The real economy has by far not recuperated the losses incurred since the beginning of the 15 years of civil war that started in 1975, when living standards were similar to those in Greece, Cyprus and Ireland. The long term prospects of the non-services sectors suffer severely from infrastructural decay, non-maintenance and political stalemates. The energy, water and telecom sectors need substantial investments that the government is barely delivering or facilitating.

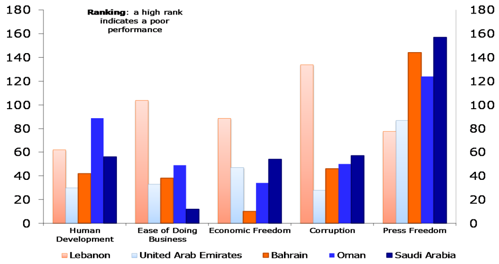
The country's incoming remittances of the often highly educated émigrés form de facto the country's main export category. In a regional perspective educational levels are high. Lebanon's universities are reputed for their quality and Beirut is the 'hospital' for the wealthy of the Middle East.

Figure 1: Growth performance



Source: EIU

Figure 2: Social indicators



Source: CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders

The economy is led by the services sector with 79% of GDP, of which banking is most noticeable and dominant in the centre of Beirut. Tourism, especially from the Gulf states and Europe, is another driving sector of the services-based economy. Agricultural output amounts to 5% of GDP, with a mixture of cash crops and food for local consumption, although a fair share of Lebanon's up-market quality wines are exported. Despite the positive effect a more broadly based agricultural development could have to social equality and political stability, the sector is not considered a priority by the central government. This is partly because the most fertile areas such as the Bekaa valley are simply not sufficiently under control of the central authorities.

The industrial sector accounts for 18% of GDP. Growth in construction is driven by increasing political and security stability, especially in the coastal areas. This stimulated demand from locals and expatriates for new housing development. Unlike large scale construction projects in the Gulf states, the Lebanese building sector is catering for a broad array of actual end-users such as wealthy Diaspora Lebanese and rich Gulf state nationals. Commercial construction projects are for the most part funded by pre-sales and equity, not by bank loans. Strict central bank regulation does not allow banks to finance more than 60% of these commercial assets' value. The risk of a real estate bust bringing down banks is small.

Lebanese banks benefit from prudent and risk averse regulations which not only results in limited exposure to real estate, but also forbade investing in American subprime securities. In addition, banks also benefit from an exceptionally strong expatriate and Gulf state depositor base. Over the past 15 years the net inflow of bank deposits continued despite on-going political instability. There has been no bank failure since the early 1970's. In 2011, the banking sector has shown robust growth. Domestic private sector credit growth has been 19% until October 2011 and the banking system's foreign assets have also grown rapidly. Overall, the sector is highly capable of enduring domestic political shocks and foreign-born financial contagion. It is expected to remain liquid and robust in the forecast period.

The economic growth estimate for 2011 is weak. GDP growth will be around 2% yoy, markedly down from 7.2% in 2010. In 2010, growth was fuelled by rising non-resident deposits, a record number of tourist arrivals, and a robust property market. In 2011, tourist arrivals have slowed in light of the regional political turmoil and the real estate sector also appears to be cooling, along with expatriate demand for housing. Furthermore, the continued unrest in Syria does not bode well for the economic prospects in 2012. Not only is Lebanon's direct exposure to Syria significant (25% of Lebanon's exports and 11% of its imports), a lot of goods exports are transported through its neighbour. Given this high level of uncertainty, it is very difficult to forecast a 2012 GDP growth figure.

Political and social situation

Lebanon has developed into a multi-religious country over the centuries. Since 1860, each of the leading (sub-)denominations of Muslims and Christians are guaranteed a representation in executive, legislative and administrative power. The civil war ended in 1990 by agreeing that, Christian (seven groups; 40% of population) and Muslim (four groups with 60% of population) members each occupy half of the seats in parliament. The president, the prime minister and the speaker of the parliament have since been a Maronite Christian, a Sunnite and a Shi'ite respectively. Power blocs are often temporary coalitions of clan leaders, more based on confessional and local interests or on personal/family relations than on political or ideological views. In this extraordinary political complexity, coalitions are rarely lasting, which causes slow -or deadlocked- decision making on critical issues. Political consensus is also needed for the full release of international donor funding, which should help to strengthen the economy.

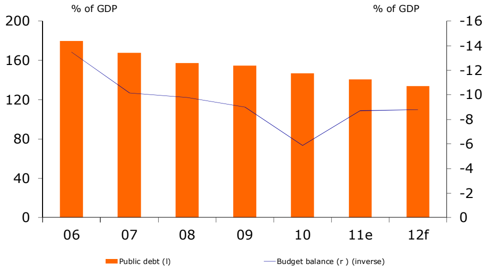
Mid-January 2011, a pro-Western, pro-market nine party coalition, the so-called March 14 alliance, lost the necessary support from 'opposition parties' like Hezbollah. Hezbollah and its allies brought down the national unity government of Saad Hariri by resigning en masse. On 14 June 2011, a new coalition government named 'March 8 alliance' was formed, after the interim government collapsed as the Hezbollah refused to participate. The new government is headed by Prime Minister (PM) Najib Mikati, an independent Sunni politician and a wealthy businessman. PM Mikati main priority is to form a stronger unity within the government and cooperation with other parties, but he faces a daunting challenge, as the new government coalition has lost the support of the "March 14" bloc, led by Mr. Hariri. As such, PM Mikati is likely to establish himself as a neutral arbiter who can mediate between the country's disparate factions and sectarian groups. However, it is more likely he will struggle to balance the political arena and will face considerable opposition from the March 14 bloc. Furthermore, he will struggle to maintain his independence from Hezbollah in the coalition and to prove himself independent of March 8, since his nomination for the premiership was backed by the armed movement. The largest reason for the dispute between the two groups centers on Mr Hariri's continued co-operation with the United Nations (UN) Special Tribunal for Lebanon (STL) investigating the assassination of former premier Rafiq Hariri's, the father of Saad Hariri. The STL indicted four members of Hezbollah on 30 June. PM Mikati faces the task of navigating Lebanon through the indictment of these suspects.

The government has said that it will cooperate with the STL, although it is not clear how it can deliver the suspects to the tribunal without threatening the collapse of the cabinet or plunging Lebanon into another political and security crisis. On the other hand, if Mikati's government ignores its international commitments, it could face international repercussions.

The US, which backs Hariri and considers Hezbollah a terrorist group, has imposed sanctions on a Lebanese Canadian Bank claiming it helped drug traffickers launder money for Hezbollah. Although the US insists the episode was the culmination of a five-year long drug-enforcement investigation, many Lebanese saw it as a warning that the US could use the banking system to put pressure on the economy if Hezbollah rose to power.

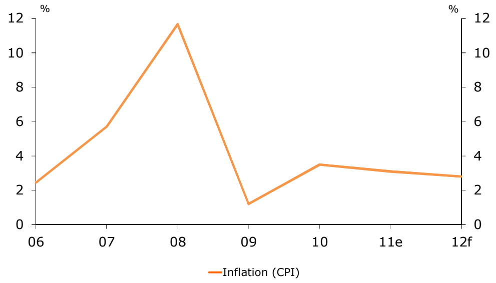
Since 2009, relations with Syria are on the mend. Syria, a former occupier of Lebanon, has traditionally acted as an intermediary in resolving Lebanon's domestic political conflicts, as has Saudi Arabia. However, Syria has been largely occupied with its own domestic affairs as the Arab Spring anti-government protests continue. It is unclear which way the Syrian crisis is heading, but the situation there will have consequences for Lebanon, particularly if the Syrian regime is weakened or overthrown, which means Hezbollah will lose a key strategic ally, which in turn could benefit PM Mikati and add to a more stable political situation.

Figure 3: Fiscal indicators



Source: EIU

Figure 4: Inflation



Source: EIU

Economic policy

After months of political deadlock, PM Mikati's government faces major challenges to get reforms and economic development off the ground. Reforms are necessary for the full release of donor funding, which is critical to the revitalization of the economy. Reforms are required in many areas, particularly in kick-starting the rationalization and privatization of state-dominated sectors, especially the water and power sectors, and telecommunications sector. Deep-seated vested interests and prolonged periods of political deadlock have prevented any substantial progress. In the past, successive Lebanese governments have not been able to properly utilize international aid and implement vital economic reforms due to the country's political troubles.

Of major concern are the persisting fiscal deficits and the very high government debt amounting to 140% of GDP in 2011, built up over the past decades. Government revenues equal around 25% of GDP. Virtually all revenues are used for current expenditures (salaries, subsidies) and interest payments, which account for 10% of GDP or a third of government expenditures. Investment outlays were a mere 2.5% of GDP over the last decade, and the prospect of improvement in the short term is low as the political stalemate continues. The budget deficit is estimated at 8.7% of GDP in 2011, and no improvement is expected in 2012 as no budget plan has been announced. As such, the fiscal position has a negative outlook.

The economy is still to a large but decreasing extent dollarized: some 66% of private sector loans and private sector deposits are in non-local currencies. The nominal peg to the dollar has been in place since 1992 at LBP 1508 to the USD and remains the sole cornerstone of monetary policy. The extension of the mandate of the present Central Bank (CB) governor in 2011, who has been in position since 1992, for another six years is an indication of the commitment to the peg. Local currency interest rates are still higher than dollar interest rates implicitly reflecting at least a perceived exchange rate and liquidity risk. The CB intervenes actively on the FX-markets to maintain the fixed peg by actively buying and selling the USD and LBP, i.e. sterilizing the exchange rate. As the interest costs of sterilizing the continuing dollar deposit inflows are high, the policy rate was cut by 200bp in 2008 to 10% and has been unchanged since.

Inflation increased to an average 6.5 % in 2011, up from 4.6% in 2010. As Lebanon is a large net importer of food and oil, the rise in global commodities prices has spurred inflation. While rising inflationary pressures inflows warrant higher interest rates, monetary policy, which is jointly set by the Central Bank and the Ministry of Finance, focuses more on the quantity of liquidity rather than its price. The authorities are reluctant to raise rates as this would signal a slide in confidence and dampen growth at a time when output is already facing headwinds. Higher policy rates would also worsen debt dynamics by increasing interest costs. However, the accumulation of a large stock of Foreign Exchange (FX)-reserves over 2008-2010 renders this policy approach feasible.

Balance of Payments

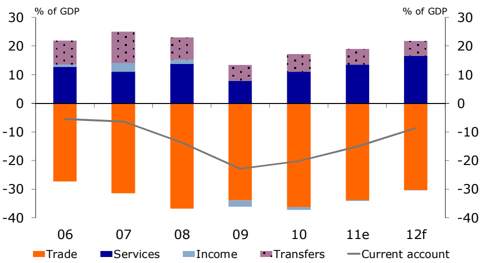
The economy of Lebanon is services based and lacks exportable natural resources and an industrial base, and the country is still rebuilding its infrastructure after a devastating civil war. Moreover, since the turn of the century a domestic demand boom has taken place in Lebanon. These factors cause goods imports to increase rapidly and the trade balance has posted large deficits over the years. In 2011, the deficit on the trade balance is estimated at a large 34% of GDP. However, this deficit is expected to be reduced in the coming years as the domestic economy slows and imports should decrease.

Offsetting the large trade balance deficit are the services and transfer balance. The services balance showed a surplus of 14% of GDP, which, with good prospects for incoming tourism revenues, should continue or may even increase substantially.

The inflowing remittances amount to 15% to 20% of GDP, but netted for outflows they are reduced to 5% of GDP. However, many deposit inflows on Lebanese bank accounts are statistically registered as a capital account item, but may in fact by their nature be remittances. Expatriates will continue to be able to wire money back home either as remittances (current account) to their families or as a deposit inflow (capital account). Whatever the registration, the net impact of these inflows is an improvement of the balance of payments. These remittances will continue as long as the economies of the Gulf region, where many Lebanese work, are growing.

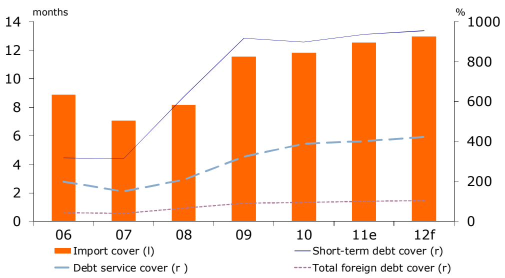
Overall, the current account has seen continuous deficits in the past years and will again post a large deficit of 15% of GDP in 2011 and a deficit of 8.6% of GDP in 2012. The financing of this deficit has been done via continuous large inflows of non-debt creating foreign direct investment which are estimated to amount to 15% of GDP for several years in a row. In addition, expatriates and non-Lebanese are willing to entrust their capital to Lebanese banks to benefit from professional services and higher interest rates with low exchange rate risk. The capital inflows more than compensate for the current account deficit. This has resulted in the accumulation of FX reserves by the central bank, which is of critical importance to defend the pegged exchange rate. The FX reserves are estimated to increase from USD 32bn at end-2010 to USD 36bn at end-2011.

Figure 5: Current account balance



Source: EIU

Figure 6: Covers offered by FX reserves



Source: EIU

External position

Total foreign debt has been increasing only slowly from around USD 30bn in 2000 to an estimated USD 35bn at the end of 2011, despite high current account deficits. But given high GDP growth over the last few years, the external debt/GDP ratio is down from 137% of GDP in 2006 to 88% of GDP in 2011, which is still a high level. Banks' liabilities to foreign depositors (individual non-Lebanese nationals residing abroad) amount to some USD 25bn of mostly a short term nature, but are excluded in the debt total of USD 35bn. The banks' external liabilities are more than covered by commercial banks' foreign assets of over USD 40bn. Only 10% of the total debt is of short term nature, the remainder is largely from private creditors (60%).

FX-reserves have risen steeply over the past years and have overtaken the gross external debt (excluding deposits from non-nationals abroad). The FX reserves stand at USD 36bn at end-2011 and represent a very comfortable 13 months of imports of goods and services. Also, the other short-term liquidity ratios are at comfortable levels as Chart 8 shows.
In addition, Lebanon maintains the largest amount of gold reserves among the central banks in the Middle East region, excluding Saudi Arabia. If its gold market value of USD 12bn at the end-2011 is included, official reserves stand at over 100% of GDP, over 15 months of imports and also the other liquidity ratios would be at more comfortable levels.

Lebanon

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	0.6	7.5	9.3	6.9	7.2	2.5	4.0
Consumer prices (average % change pa)	2.4	5.7	11.7	1.2	3.5	3.1	2.8
Current account balance (% of GDP)	-5.4	-6.4	-13.7	-22.9	-20.2	-15.2	-8.6
Total foreign exchange reserves (mln USD)	13376	12910	20245	29103	32362	35700	37520
Economic growth							
GDP (% real change pa)	0.6	7.5	9.3	6.9	7.2	2.5	4.0
Gross fixed investment (% real change pa)	2.8	20.3	18.0	6.0	9.3	7.1	8.1
Private consumption (real % change pa)	-2.1	6.6	9.5	7.1	7.0	2.8	4.1
Government consumption (% real change pa)	2.6	4.5	8.6	5.1	2.1	3.9	3.2
Exports of G&S (% real change pa)	-0.9	13.8	13.7	11.0	8.2	6.5	6.1
Imports of G&S (% real change pa)	-3.2	17.2	16.9	8.4	7.0	7.1	7.8
Economic policy							
Budget balance (% of GDP)	-13.5	-10.2	-9.8	-9.0	-5.9	-8.7	-8.8
Public debt (% of GDP)	180	168	157	155	147	140	134
Money market interest rate (%)	5.2	5.2	5.2	4.9	4.5	4.7	5.0
M2 growth (% change pa)	8	12	15	20	12	10	12
Consumer prices (average % change pa)	2.4	5.7	11.7	1.2	3.5	3.1	2.8
Exchange rate LCU to USD (average)	1508	1508	1508	1508	1508	1508	1508
Balance of payments (mln USD)							
Current account balance	-1221	-1605	-4103	-7555	-7225	-6060	-3850
Trade balance	-6115	-7880	-11010	-11179	-12965	-13480	-13580
Export value of goods	3229	4046	5251	4716	5089	5610	6090
Import value of goods	9345	11926	16261	15895	18054	19080	19670
Services balance	2847	2767	4110	2564	3976	5400	7440
Income balance	184	740	437	-767	-393	-140	-10
Transfer balance	1864	2769	2361	1827	2157	2160	2300
Net direct investment flows	1800	2528	3346	3678	4614	5130	5720
Net portfolio investment flows	-1882	-2568	-1620	-1473	-1546	-1510	-1530
Net debt flows	4139	2230	-748	871	885	1140	600
Other capital flows (negative is flight)	-276	780	10851	15368	8846	4010	1230
Change in international reserves	2560	1366	7727	10889	5574	2720	2170
External position (mln USD)							
Total foreign debt	30826	31713	30611	31892	34162	35280	35880
Short-term debt	4200	4118	3246	3173	3604	3810	3930
Total debt service due, incl. short-term debt	6696	8613	9700	8972	8316	8890	8890
Total foreign exchange reserves	13376	12910	20245	29103	32362	35700	37520
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-27.3	-31.4	-36.8	-33.9	-36.2	-33.8	-30.3
Current account balance (% of GDP)	-5.4	-6.4	-13.7	-22.9	-20.2	-15.2	-8.6
Inward FDI (% of GDP)	11.9	13.5	14.5	14.6	15.4	15.2	14.9
Foreign debt (% of GDP)	137	127	102	97	95	88	80
Foreign debt (% of XGSIT)	138	126	97	105	102	98	91
International investment position (% of GDP)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	30.0	34.3	30.7	29.7	24.9	24.6	22.6
Interest service ratio incl. arrears (% of XGSIT)	9	9	7	8	7	7	6
FX-reserves import cover (months)	8.9	7.1	8.2	11.6	11.8	12.5	13.0
FX-reserves debt service cover (%)	200	150	209	324	389	402	422
Liquidity ratio	185	178	165	187	193	202	211

Source: EIU