Special Report

Republic of Lebanon --- Concerns of Increasing Political Instability Grow, Even as Lebanon Takes First Steps toward Fiscal Reconstruction

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	Rating	Rating Outlook
Foreign Currency Issuer Rating	BB	Negative
Foreign Currency Short-term Credit Rating	a-3	-

Lebanon's economy is improving as capital inflows expand together with the boom in Middle Eastern oil-producing countries, against the backdrop of high oil prices. Despite a heavy burden of external debt accumulated during the reconstruction process following the end of its civil war, Lebanon is receiving financial support on favorable terms from foreign governments and public institutions as the result of an international conference in Paris in November 2002, and its interest payment burden has been reduced.

Although Lebanon introduced a value added tax (VAT) in the second half of 2002 and halted its fiscal deterioration, the government is expected to continue running a fiscal deficit of about 10% of gross domestic product (GDP) in 2005. Lebanon's ability to continue reconstruction, jump-started by the introduction of foreign capital, will depend on domestic political stability and progress towards peace in the Middle East.

Expectations have increased that Syria will withdraw its troops stationed in Lebanon (Note 1) by the general election in May, because of strong international pressure. How the resulting political vacuum will be filled, however, is a key issue. Former Prime Minister Rafiq Hariri, the key mover behind the reconstruction after 15 years of continual civil war until 1990, was assassinated in February. Fears have emerged that Lebanon's national political arrangements, built on a delicate slight balance among various religious groups, will be destabilized, and must be monitored closely.

Lebanon gradually regains its former sparkle

Lebanon's capital Beirut is a beautiful port city. To drive east out of Beirut and climb into the Anti-Lebanon Mountains, which soar on the eastern edge of the country, is to be rewarded with an expansive view of several Arab countries, including Syria, Jordan and Iraq, spread across one's field of view. From the opening of its port in 1860 to the eruption of its civil war in 1975, Beirut was a base of finance and trade for these Arab countries, and a cosmopolitan city where information and resorts were available for all.

Beirut has also always had a sense of intimacy with this same Arabic speaking region, and been a familiar presence for oil producing countries such as Kuwait and Saudi Arabia, while also functioning as a safe haven for capital during periods of political unrest and civil disturbance in surrounding Arab states. Although its position as a financial center was usurped by Bahrain and Dubai during its civil war, the scale of Lebanon's bank assets is still 3.3 times its gross domestic product (GDP), a level that ranks with Switzerland. Roughly 10 million Lebanese – three times the size of the domestic population – have emigrated to other countries, and the large sums they remit support personal consumption and play a role in Lebanon's reconstruction. Many of Lebanon's bank deposits are also such remittances from foreign countries, which provide banks with an extremely strong funding base. Lebanon never missed a payment on its external debt during the civil war only because the banks, holding ample deposits, were able to underwrite the government's bonds.

The old vitality has returned to Beirut. It has been said the terrorist attack in the U.S., and the subsequent invasion of Iraq, marked a boundary line. Arab money, which until then had flowed toward the United States, started to shift to the Middle East, and the movement of people in the region also became more active, a trend spurred even further as the gulf oil-producing nations have grown richer with the high price of crude oil. In 2004, the number of tourists broke through the important one million visitors mark. Although this has yet to match the peak, when visitors reached 1.5 million to 2 million annually, there is no mistaking the fact the number of tourists has been climbing. With intermediate transit trades linked to the rebuilding of Iraq growing as well, the economy is slowly expanding, and real GDP in 2004 grew 5% compared with the previous year.

There is no guarantee the boom will continue in the future, however. One source of concern is that investment capital from the Gulf states is biased towards real estate. Infrastructure investment, including roads and bridges, is minimal. Employment practices are rigid, and young people who receive a higher education have a strong desire to emigrate. There is fear that should this area, known as the powder keg of the Middle East, be struck by war again, the economic stability Lebanon has begun finally to achieve at great pains will collapse all too easily. The key to the political power balance that will guarantee economic prosperity is the posture of the U.S., the one country capable of exercising a strong influence on the players crucial to a Middle East peace, such as Israel, Palestine and Syria. For this reason alone, there is also immense interest in Lebanon in the Middle East policy of the Bush administration as it enters its second term.

A giant star is extinguished, and imponderable dark clouds gather

The prime mover behind Beirut's revival was undoubtedly former Prime Minister Hariri, who was killed in a car bombing in February 2005. Hariri, who moved to Saudi Arabia as a young man and made his fortune by leveraging his construction company into a relationship with the Saudi royal family, was also involved in the 1989 Taif Agreement (Note 2) to end the civil war. Hariri demonstrated a keen sense of political balance, and served as Prime Minister a total of five times between 1992 and 2004. As the largest shareholder in the construction company Solidere, he also led the reconstruction activities centered on redevelopment of Beirut. Although Lebanon's foreign debt rose to more than US30 billion dollars, Hariri's government avoided fiscal collapse by successfully participating in an aid conference to tackle Lebanon's public debt crisis, hosted in Paris in November 2002 by French President Jacques Chirac, with whom Hariri was on friendly terms. As a result, Lebanon obtained a total of US4.4 billion dollars in financial support from advanced countries and international organizations.

There was friction, however, between Hariri and Lebanese President Emile Lahoud, who has close ties with Syria. Lebanon's parliamentary democracy, with its system to achieve and maintain a political balance among the Maronite Christians, Sunni Muslims and Shia Muslims, the three main religious sects, stipulates that the president be selected from the Maronite sect, the Prime Minister from the Sunni Muslim sect and the Speaker of the legislature from the Shia Muslim sect, based on the national agreement in 1943 that gave Lebanon its independence from French colonial control. The strongest authority, however, is recognized to reside with the president. Because the

■ Setting of assumptions and conditions

	2003 (Actual)	2004 (Estimate)	2005 (Projected)	2006 (Projected)	2007 (Projected)	2008 (Projected)	2009 (Projected)	2010 (Projected)
Scenario 1								
Real GDP growth rate (%)	3.0	5.0	4.0	4.0	4.0	4.0	4.0	4.0
Nominal GDP growth rate (%)	5.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Government bond weighted average interest rate (%)	10.0	8.3	8.1	7.9	7.9	7.9	7.9	7.9
Scenario 2								
Real GDP growth rate (%)	3.0	5.0	4.0	3.5	3.0	3.0	3.0	3.0
Nominal GDP growth rate (%)	5.0	7.0	6.0	5.5	5.0	5.0	5.0	5.0
Government bond weighted average interest rate (%)	10.0	8.3	8.3	8.3	8.5	8.7	8.9	9.1
Scenario 3								
Real GDP growth rate (%)	3.0	5.0	4.0	3.0	2.0	2.0	2.0	2.0
Nominal GDP growth rate (%)	5.0	7.0	5.0	4.0	3.0	3.0	3.0	3.0
Government bond weighted average interest rate (%)	10.0	8.3	8.7	9.1	9.1	9.1	9.1	9.1

Source: Prepared by R&I

president's authority was reduced after the Taif Agreement, and the Prime Minister's authority in the provinces expanded, the tug-of-war between the two leaders grew more intense across the entire range of diplomatic and domestic affairs.

When the constitutional amendment extending President Lahoud's term of office for three years was passed in October 2004, Prime Minister Hariri, who had opposed it, resigned and the confrontation between the two men became clear. Fears have also emerged that reconstruction works will be delayed as a result of Hariri's assassination.

Approximately 500,000 Syrian workers, who account for more than 10% of Lebanon's total population and work mainly at locations such as construction sites, have supported the reconstruction of Beirut in the shadows. A movement by many workers to return to their home country has begun, as anti-Syrian feelings in Lebanon have been heightened by ongoing terrorist incidents. If this movement becomes a full-scale exodus, the affect on Lebanon's economy is likely to be negative.

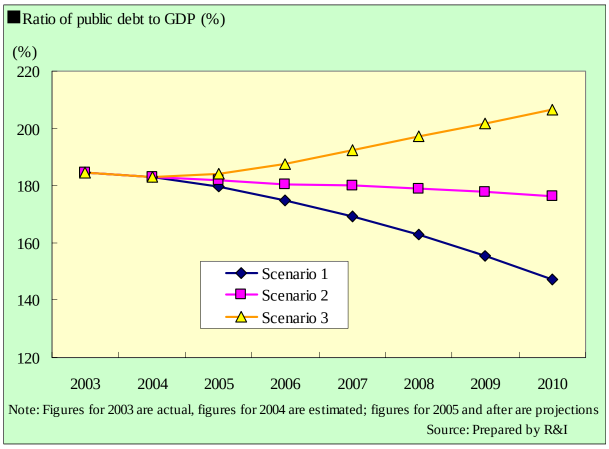
Fundamental fiscal balances vastly improved by introduction of a value added tax

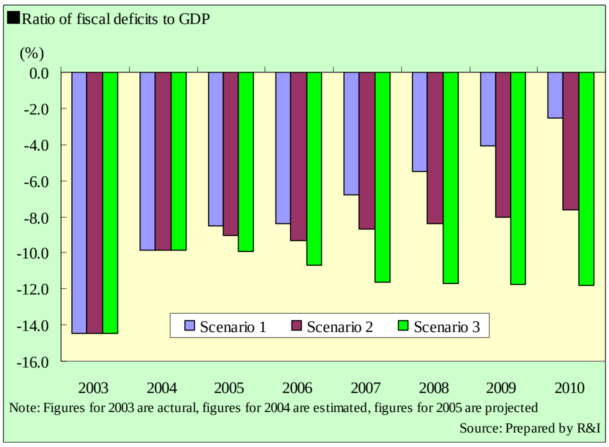
In 2001, Lebanon faced a situation where its fiscal deficit was 16.8% of GDP, and the balance of public debt was 170% of GDP. Because both indicators were remarkably unfavorable compared with other countries, and the orientation was towards further deterioration, in 2002 R&I downgraded Lebanon's Foreign Currency Long-term Credit Rating to BB from BB+, and assigned a negative rating outlook. Although Lebanon avoided further deterioration because of the support agreed upon at the Paris conference, in 2004 the fiscal deficit was 10% of GDP and public debt also remained at 183% of GDP, and there was no change in the circumstances compelling severe fiscal management.

At the Paris conference, the Lebanese government extracted pledges for grants of long-term, low-interest financing by explaining to donor countries its future policies, including fiscal reform and privatization, which enabled Lebanon to redeem its short-term, high coupon debt. With the pledges in place, the local commercial banks responded by converting, over a two-year period, roughly US3.6 billion dollars worth of government bonds to government bonds with less favorable conditions at no interest. Moreover, the central bank responded by canceling US1.8 billion dollars worth of government bonds it held against revaluation gains of its gold holdings to the market value, and exchanging public debt equivalent to US2.3 billion dollars for new government bonds. These measures were received favorably, and since 2004 the interest rate on two-year government bonds has declined to the 7% level.

Because it has mitigated its interest payment burden, the government has been able to shrink the size of the fiscal deficit. To reduce the deficit further, the government introduced a 10% value added tax (VAT) in the second half of 2002.

Behind Lebanon's growth into one of the largest centers for finance and trade in the Middle East is the government's laissez-faire policy, which keeps government interference in the private sector at a





minimum. In this respect, Beirut resembles Hong Kong, with its low taxes. Providing the rapidly expanding capital for reconstruction with taxes was difficult, however, and Lebanon had no alternative but to rely on borrowing from abroad and procuring funds at high rates from domestic banks. As noted from the fact the interest payment burden on government bonds at one point reached 80% of annual revenues, Lebanon had fallen into a vicious circle and could not avoid further expansion of its debt in order to make principal and interest payments.

It was under such circumstances the introduction of the VAT was hammered out. The results exceeded government expectations. When the results for January through September 2004 are examined, the VAT accounted for 26.3% of annual revenue, bounding into the top spot and surpassing other tax items. Primary fiscal balances excluding net interest payment turned into a surplus of 2.04 trillion Lebanese pounds, more than double the amount in the previous year, and improved to over 5% of GDP.

Lebanon has a high VAT efficiency ratio, an indicator that shows the amount of VAT revenue to GDP for each 1% of the VAT tax rate. For advanced nations such as Japan, the U.S. and European countries, the mean VAT efficiency ratio is 0.4-0.5, while the typical ratio in developing countries where tax collection systems tend to lag is around 0.3. Lebanon has achieved a ratio of 0.6.

Whether it is because Lebanon's underground economy, which doesn't appear in official GDP statistics, is fairly large, or because it's a small country with an open economy, where the relative weight of imported items and services subject to tax is high, for reasons not clearly understood Lebanon is showing large tax collection capacity. If Lebanon can make the VAT permanent and maintain its economic boom, there is even a possibility for the ratio of public debt to GDP to begin falling in 2005. Should the growth scenario be thrown off track by political factors, and the government fail to obtain sufficient confidence from the market and interest rates rise when the government refinances its debt, however, public debt would probably rise to over 200% of GDP within just a short time. The world is watching closely to see whether the next Prime Minister, who will take office after the general election in May, will continue on the road to fiscal revival bequeathed as Hariri's parting gift, and further open the economy.

Mutually dependent banks and government

While the worst situation was avoided, the government still faces considerable refinance risk. The average remaining term on government bonds is longer than was previously the case, but nevertheless, the government must redeem or refinance US2.5-3.0 billion dollars in external debt and US7.5 billion-8.0 billion dollars in domestic debt every year from 2005 onward. Assuming it maintains the fiscal deficit at roughly US1.5-2.0 billion dollars each fiscal year, the government will have to issue bonds totaling US12.0-13.0 billion dollars every year. The increase in interest expense, if the average domestic and international market interest rates reverse course and rise by even 1%, cannot be disregarded. With the exchange rate pegged at one US dollar = 1,507 Lebanese pounds, it is likely the ripple effect of successive hikes in the U.S. policy interest rate since 2004 on Lebanese pound interest payments will be impossible to ignore.

Lebanon's domestic commercial banks, which hold most of the government's bonds, also hold the key to any refinancing. The commercial banks have total assets equivalent to 3.3 times Lebanon's GDP (approximately US60.0 billion dollars when converted to U.S. dollars), of which about 80% are deposits. With a shift into dollars, however, 66% of these were dollar deposits at the end of 2003. To gather deposits from around the world the government is exercising its ingenuity, including setting interest rates higher for pound deposits than U.S. dollar deposits, and keeping the withholding tax on interest earnings at 5% compared to 20% in the United States. The

■ Ratio of interest payment expense to annual revenue (%)

	2003	2004	2005	2006	2007	2008	2009	2010
Scenario 1	73.2	61.1	58.8	56.0	54.4	52.5	50.3	47.8
Scenario 2	73.2	61.1	60.9	60.6	61.9	63.1	64.1	65.0
Scenario 3	73.2	61.1	64.6	68.7	70.5	72.3	74.0	75.7

Note: Figures for 2003 are actual, figures for 2004 are estimated; figures for 2005 and after are projections

Source: Prepared by R&I

government's efforts to stay focused on sound management also cannot be overlooked.

Investments are a problem. Until 2004, overseas lending was limited, and even though lending is restricted to domestic loans, outstanding balances have already reached about 90% of GDP. For a country where per capita GDP is about US4,000 dollars, this is a high level. There is quite little room to increase lending further, and no means to invest in anything other than government bonds. When negotiable certificates of deposit (CDs) issued by the central bank from a monetary policy perspective as a means to absorb capital are included, the public sector had absorbed approximately two-thirds of all deposits.

At present, there appears to be no reason to be concerned about inflation caused by the government bond issues. Since 1997, the rate of annual increase in consumer prices has remained 4% or less, and is expected to remain in the range of 2-3% in 2005 as well. Moreover, this has not resulted in a situation where capital to the private sector has stopped because of crowding out by government bond issues. The decline in interest rates for both loans and deposits will continue for several more years, regardless of whether funds are in dollars or pounds.

The present situation, in which the fiscal deficit will be supplemented using banks' assets, appears set to continue for a while. The reason is capital strength and financial strength remain with the banks. According to Lebanon's Banking Control Commission, however, the ratio of banks' non-performing loans at the end of 2004, even if reserves are subtracted, was about 12.2%, by no means a satisfactory level. Competition among banks also is not sufficient. So long as Lebanon remains just a country through which capital flows in and out according to political whim, and fiscal management that anticipates capital inflows from overseas continues, it will probably be difficult to upgrade Lebanon's creditworthiness to investment grade.

Course of the worrisome U.S. policy in the Middle East

Whether Lebanon will be able to maintain its growing economy, and make improvements to its fiscal deficit in the future, will depend on the progress towards Middle East peace, including final resolution of the demands of the Palestinian people. However, the situation in the Middle East region surrounding Lebanon does not allow for an optimistic view.

The campaign to bring democracy to the entire Arab region, which was urged by the United States and launched with the attack on Iraq, has only made the complex feelings of citizens in Middle Eastern countries towards the U.S. even more complicated. Whether this manifested itself in Lebanon in the form of the assassination of Prime Minister Hariri is impossible to say. Regardless, the assassination of Hariri has unmistakably brought political instability. Sooner or later, the U.S. will take aim at eliminating Hizbollah (Note 3), which Syria supports. Although Syria declared an early withdrawal of its troops stationed in Lebanon in a form intended to show its respect for U.S. military might, it seems unlikely Syria will simply withdraw so easily. What kind of steps all of the parties will take next is quite unpredictable. Syria's army proved useful in constraining the power of the Palestine Liberation Organization (PLO) in Lebanon, and for that reason alone, the question of how to fill the military vacuum caused by Syria's withdrawal is expected to be convoluted. The U.S. will probably always consider Hizbollah a terrorist organization and demand that it disarm, and opposes efforts by the main parties in Lebanon to deal with Hizbollah as another political organization. On this matter, there appears to be no easy way to close the gap between the two countries.

As long as peace is not achieved between Israel and Palestine, armed clashes in southern Lebanon between Hizbollah and Israel are unlikely to diminish, and Lebanon's political situation, in which the interplay among factions and grievances that led to civil war has not been eliminated, is unlikely to change. Moves towards reconciliations that have arisen between Israel and Palestine since the death of former PLO president Yasser Arafat, also appear unlikely to proceed easily. In Lebanon's case, a cooling down of the Middle East political situation and stabilization of its domestic politics will be indispensable for economic growth, and R&I will continue to monitor closely the situation throughout the Middle East and within Lebanon. *(end)*

■ Key economic indicators

	1997	1998	1999	2000	2001	2002	2003	2004
Real GDP growth rate (%)	4.0	3.5	1.0	-0.5	2.0	2.0	3.0	5.0
Increase in consumer price index (%)	7.7	4.5	0.2	-0.4	-0.4	1.8	1.3	2.0
Fiscal revenue and expenditures/GDP (%)	-25.6	-15.1	-16.2	-24.6	-18.9	-15.1	-14.6	-9.9
Trade balance (US million dollars)	-6,824	-6,408	-5,530	-5,555	-6,402	-5,400	-5,300	
Current balance/GDP (%)			-18.5	-17.3	-21.2	-13.8	-13.1	-12.2
Foreign currency reserves (US million dollar	5,976	6,556	7,776	5,944	5,014	7,244	12,519	12,265
External public debt (US million dollars)		4,176	5,529	6,951	9,554	14,540	15,524	
External debt/GDP (%)		25.6	33.5	42.4	57.3	84.1	86.0	
US dollar exchange rate	1507.5	1507.5	1507.5	1507.5	1507.5	1507.5	1507.5	1507.5

Sources: Prepared by R&I from IMF International Financial Statistics and the website of the Central Bank of Lebanon

(Note 1) Syria's army advanced into Lebanon in 1976 as an "Arab Peacekeeping Force" immediately after the outbreak of Lebanon's civil war, during which the Palestine Liberation Organization (PLO), with Muslim support, clashed with Maronite Christian militiamen. Although bringing an end to the civil war was the stated pretext, the real purpose was to prevent the PLO from gaining power, a goal that earned implicit consent from the U.S. and Israel. Following Syria's participation in the Gulf War alliance in 1991, the United States continued to tacitly approve Syria's control in Lebanon. At the end of March 2005, Syria's forces were estimated to number about 14,000 personnel.

(Note 2) In October 1989, representatives of each Lebanese party gathered in Taif, Saudi Arabia and signed the Document of National Accord (the "Taif Agreement") to settle the Lebanese civil war, which had raged since 1975. The agreement incorporated various provisions, including political reforms, such as evenly allocating seats in Lebanon's parliament to Christians and both Muslim sects, and withdrawal of Syrian military forces stationed in Lebanon to the Baqa'a Valley by 1992. Based on this mutual agreement, the civil war ended the following year in the autumn of 1990.

(Note 3) Hizbollah (Party of God) is a Muslim Shia fundamentalist group formed after Israel invaded Lebanon in 1982. Currently estimated to have 3,000 to 4,000 armed fighters, Hizbollah's aim is the foundation of an Islamic republic along the lines of Iran and the elimination of all non-Islamic influences, and from its bases in southern Lebanon has repeatedly staged armed attacks against Israel. Assumed to have received protection from Syria, and criticized by the United States as a terrorist organization, Hizbollah is respected by the other political forces in Lebanon as a symbol of opposition to Israeli dominance