

Economic

Credit Agencies

Moody's: B3
S&P: B-
Fitch: B-

Nominal GDP (2005)

US\$22.0 billion

Population (2005):

3.8 million

External Debt/ Exports (2005):

385%

Currency:

Lebanese pound

Exchange regime:

LL1507.5 / 1USD

Merchandise imports from Canada: 2005

Cdn\$40.5mn

Main sources of Foreign Exchange (excl. FDI):

Remittances

Largest Merchandise Trading Partner:

France

Main imports:

Petroleum products, cars, consumer goods

Risks to the Outlook



Buoyancy of GCC & support from Lebanese diaspora



Regional insecurity & large public debt.

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Market Spotlight: Prior to the conflict with Israel, Lebanon was doing quite well. It demonstrated resilience to shocks. The financial situation had stabilized as deposits inflows resumed accompanied by dedollarisation. Confidence had returned, but vulnerabilities remained below the surface. The 2006 conflict will be remembered as a major economic setback. The improvement on the fiscal position will be reversed. Tourism is experiencing a major setback. While the reconstruction will probably be supported by some Gulf countries money and workers' remittances, a good share of major rebuilding projects will have to be financed by the public sector. This will add to Lebanon's already heavy public sector debt burden.

Economic performance: GDP growth slowed down markedly in 2005, as public and private sector demand contracted during last year political crisis. Nevertheless, export growth led to GDP growth rate of 1% while inflation dropped to less than 0.5%. Growth, which was expected to accelerate in 2006 helped by the buoyancy of its oil-producing neighbors, will be flat at best this year. When the reconstruction will be possible, growth will bounce back.

Fiscal policy: The budgetary deficit, which had been reduced from double to single digits (as a % of GDP) in 2005, will widen again to at least 15% of GDP with the reconstruction needs. High interest rates have been required to finance the government's budgetary deficit, and more specifically the servicing of Lebanon's huge public debt.

Financial Sector: Banks provide the majority of private and government financing. This makes the soundness of the banking sector a key policy concern. While banks remain profitable and well capitalized, they face vulnerabilities due to their exposure to the sovereign and depositor confidence. One reason that allows Lebanon to sustain a higher than normal debt burden is the large size of the banking sector – M2 to GDP is 236%, making it second only to Hong Kong and twice the average for developed countries, let alone emerging markets. Lebanese banks hold around 50% of all public debt. As for capital markets, they are underdeveloped and this has hindered private sector development. Following Hariri's assassination US\$2bn were withdrawn and US\$5.5bn were converted in dollar deposits. But, by mid-2005 the financial situation had stabilized. Deposit inflows resumed and the trend was accompanied by gradual dedollarisation. The US\$750mn Eurobond issue in October 2005 was largely oversubscribed. By mid-March 2006 Eurobonds spread had declined. However, capital flight will be again an issue.

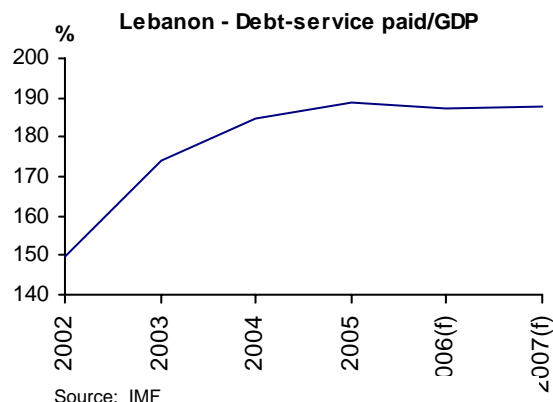
External sector: The balance of payments is characterized by a large trade deficit, as the export base is limited. Services (tourism receipts and workers remittances) equivalent to 40% of GDP have contained the external current account deficit. Prior to the conflict with Israel, it was supposed to be in the area of US\$3bn equivalent to 12-13 % of GDP during 2006-07. Now it is expected to be much larger due to the import needs and lower tourism receipts. Foreign exchange reserves were in the area of US\$12bn, as at 15 July, equivalent to 7.6 months of imports of goods and services.

External debt: The public debt-to-GDP ratio grew from 150% in 2002 to 190% by mid- 2006, one of the highest in the world. This means that Lebanon remains acutely vulnerable to economic and political shocks. An upward movement in global or domestic interest rates, which would increase the cost of debt servicing, or weaker-than-expected growth, could make the country's debt ratio unsustainable once again. The financing of the rebuilding will add additional pressures on an already heavy debt burden. Large liquid foreign holdings of commercial banks offer a crucial first line of defense against shocks.

Outlook: *The short-term outlook is very preoccupying. The medium-term outlook shows vulnerabilities & is threatened by the heavy debt overhang.*

| Economic Indicators | | | | |
|-------------------------------|------------|--------|----------|----------|
| | 00-04 avg. | 2005 | 2006 (f) | 2007 (p) |
| GDP (% growth, real) | 3.0 | 1.0 | 0.2 | 3.5 |
| Inflation (% , year-end) | 2.0 | 0.3 | 4.9 | 2.0 |
| Fiscal Balance (% of GDP) | -15.7 | -8.0 | -15.0 | -14.5 |
| Exports (US\$ bn) | 1.4 | 1.8 | 1.5 | 2.2 |
| Imports (US\$ bn) | -8.6 | -8.7 | -10.5 | -9.9 |
| Current Account (% of GDP) | -17.1 | -12.7 | -15.5 | -13.5 |
| Reserves (month of imports) | 10.3 | 9.0 | 7.6 | 7.0 |
| Total External Debt (US\$ bn) | 30.0 | 38.5 | 40.5 | 42.5 |
| Debt Service ratio | 17.0 | 26.8 | 14.0 | 11.1 |
| Currency (per US\$, year-end) | 1507.5 | 1508.0 | 1508.0 | 1508.0 |

Source: EIU, EDC Economics



General Political Environment:

Lebanese politics is shaped by the influence of religious politics, with the balance of power broadly reflecting the societal division between the Shia, Druze and Christian communities.

As a result of Syrian influence, the Lebanese government passed a constitutional amendment in September 2004 extending Syrian-backed President Emile Lahoud's term by three years. The extension triggered significant anti-Syrian opposition both within and outside of Lebanon.

Opposition to Syrian military and political dominance in Lebanon peaked following the assassination of former Lebanese Prime Minister Rafik Hariri on February 14, 2005. Allegations of Syrian involvement in the assassination prompted street demonstrations in Beirut calling for the withdrawal of the some 14,000 Syrian troops in the country. In due course, the pro-Syrian government fell and Syria responded with a full military withdrawal by April 2005.

Tensions will continue to run high within Lebanon pending the final outcome of the UN inquiry into Hariri's assassination. The mandate of the investigation was recently extended to June 2006 and may well be extended further. The investigation's outcome, carrying with it the potential for an implication of senior Syrian officials, may well also galvanize the forces within Lebanon which are seeking the resignation of pro-Syrian President Lahoud.

On July 12, Lebanese Shia militant group Hizbollah captured two Israeli soldiers and killed eight others in a cross-border raid into Israel. Israel labelled the action an act of war and is responding with a full-scale military campaign against an array of targets across Lebanese territory.

Investment Environment:

Lebanon offers the most liberal investment climate in the region. There are no significant restrictions on foreign investment, conversion restrictions or limitations on the movement of capital, remittances, and dividends. Corruption, however, remains prevalent at all levels of government and remains a serious obstacle for investors.

The establishment of a new centre for arbitration allows commercial disputes to be settled much more rapidly than in the past. Lebanese law also allows for the enforcement of international arbitral decisions, though it is neither a signatory to ICSID nor the New York convention on the recognition and enforcement of Foreign Arbitral Awards.

Political Violence:

Following the assassination of former PM Rafik Hariri, several large-scale demonstrations – pro and anti-Syrian – occurred in the capital. In March 2005, three bomb attacks occurred in predominantly Christian areas near Beirut and reports of violence against Syrian workers were reported.

Security risks are high throughout Lebanon but particularly southern Lebanon and southern Beirut following the launch of an Israeli military campaign on July 12. Targets can include Hizbollah positions/installations but also Lebanese infrastructure such as roads and bridges with the Beirut International Airport having sustained repeated attacks. Regardless of the intensity of the current Israeli military campaign against Lebanon, Hizbollah is highly unlikely to release the Israeli soldiers unless there is a prisoner swap. The Israelis appear uninterested in negotiations at this early stage and will continue the campaign until their range of strategic targets in Lebanon have been hit.

There is a high risk of limited Israeli military ground incursions in an attempt to dismantle Hizbollah's rocket-launching capability along the Lebanese-Israeli border.

Political

Political Structure

Parliamentary Democracy

President

Lt. General Emile Lahoud

Prime Minister

Fouad Siniora

Parliamentary Speaker

Nabih Berri

Legislative Body

National Assembly (Majlis al-Nuwab): (128 elected members divided along religious lines)

Senate (40 members) – appointed

Major Parties

Rafiq Hariri Martyr's List (includes Saad Hariri's Future Movement, the Progressive Socialist Party and the Qornet Shehwan Gathering) – 72 seats; Resistance and Development Bloc (includes Amal and Hizbollah) – 35 seats; Free Patriotic Movement – 21 seats

Last Elections

Presidential: October 1998

Parliamentary: May / June 2005

Next Elections

Presidential: expected in 2007

Parliamentary: 2009

Press Freedom Survey:

• 2005 Score: 60 (Partly Free)
freedomhouse.org

Control of Corruption Index:

• 2004 Score: -0.51
(-2.5: Worst; +2.5: Best)
worldbank.org

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Political Outlook

The continuing escalation of violence seriously threatens to undermine the stability of the fragile Lebanese government. PRAD does not assess that it is Israel's goal to see the anti-Syrian government of Prime Minister Fouad Siniora fall. Assuming this to be true, this factor acts an important mitigant against the risk of a protracted Israeli military campaign in Lebanon.