

July 2006

## Lebanon – Credit Outlook



[www.pytheas.net](http://www.pytheas.net)



**The credit outlook is negative** and it is in response to the escalating crisis between Lebanon and Israel and reflects the considerable uncertainty concerning the duration and intensity of military attacks and the possible impact on the economic and political stability of Lebanon. The revision of the sovereign and financial institutions ratings to negative should not be a surprise.

Large government and external financing needs and a public sector debt stock of 175% of GDP, of which over 50% is in foreign currency, leaves Lebanon highly vulnerable to political and economic shocks. The government has a limited funding base and depends on the domestic banking sector for the bulk of its financing needs.

**Although the country has proven remarkably resilient to past shocks, and PYTHEAS would expect a crisis of limited duration not to significantly affect short-term repayment capacity, it shall have longer-term implications for economic activity and the public finances.**

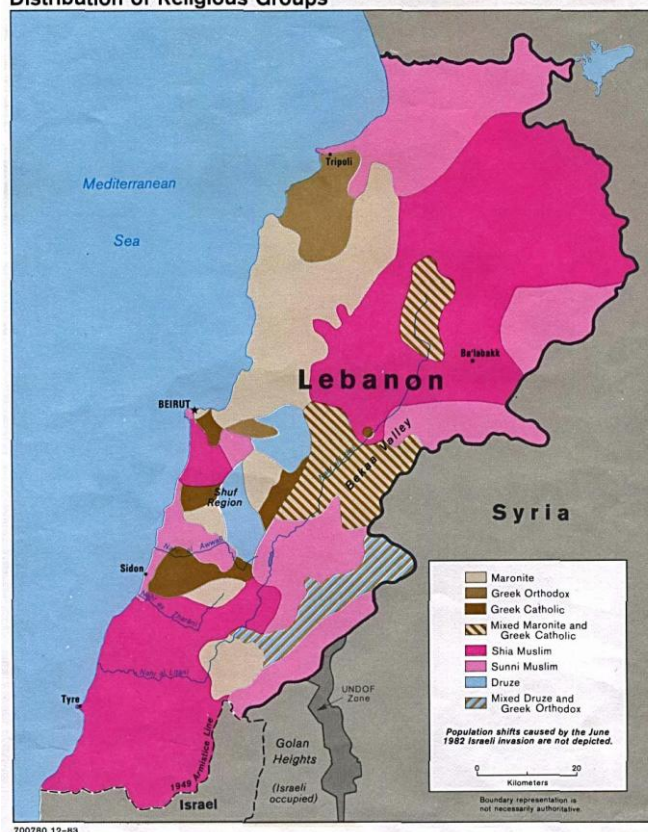
PYTHEAS notes that on the eve of the crisis, official foreign exchange reserves amounted to about USD11 billion while the foreign assets of the commercial banking sector, which are mostly held with correspondent banks abroad, were close to USD15 billion. Put together, these foreign assets cover around 52% of estimated foreign currency debt falling due over the next 12 months, including principal payments on government Eurobonds, which amount to a manageable USD440mn, and all foreign currency deposits in the banking sector (USD43 billion). **While foreign currency deposits are usually rolled over, they are a potential source of systemic risk to the banking system and a large-scale and rapid withdrawal of such deposits would make government financing and the management of the fixed exchange rate regime extremely challenging.**

Lebanon's economic position shall deteriorate markedly as a result of this war. The positive recent economic performance which was being driven by a rebound in tourism (unless a miracle happens by the Christmas and New Year holiday season) and strong performance of exports will be no more. The ability of companies to function and export shall be handicapped by the damage to infrastructure – which the Israel forces seem to have as primary target. The loss in private income and sentiment thus private consumption is another major predicament the extent of which we will be able to evaluate only after the end of the conflict.

The fiscal deficit will widen as tax revenues fall with the contraction in business activity. The trade deficit will deteriorate given the destruction to the production and export capacity. Imports will be driven higher by the rebuilding process which by only the first nine days of the conflict seem to be already immense. The services account will deteriorate as tourism revenue plummets. Inflation will accelerate. Black market will flourish once more.

Despite that PYTHEAS acknowledges that, (a) the country is unlikely – although not highly unlikely – to default on its illiquid and closely-held sovereign debt; (b) the country's local and regional backers who have sunk their petrodollars into Lebanon's real estate sector could step

Distribution of Religious Groups





up and provide direct and indirect support; (c) more than 60 percent of Lebanese cash debt is owned by “Lebanese investors” and in general over time it reacts really slowly to good or bad news because it is a captive market; **if friendly nations and the other affected business entities do not come to Lebanon’s rescue, Lebanon could easily find itself in its worse financial situation of the past two decades!** Moreover, considering the vulnerable and complex political and religious amalgamate of the country, a prolonged armed conflict with Israel could escalate to an internal civil unrest.

**Opinion: Nevertheless, it is PYTHEAS opinion that the situation is extremely fluid and the longer the crisis continues, the greater the downside risk to economic and financial stability.**

**Considering the vulnerable political and religious amalgamate of the country a prolonged armed conflict with Israel could lead to an internal civil unrest.**

Disclaimer

The above notes have been compiled to assist you; however, actions taken as a result of this document are at the discretion of the reader and not Pytheas Limited.