Euler Hermes Economic Research

Country Report

Lebanon

Tough structural challenges lie ahead

General Information

GDP	USD47.1bn (World ranking 82, World Bank 2015)
Population	5.85mn (World ranking 111, World Bank 2015)
Form of state	Republic
Head of government	PM Saad HARIRI
Next elections	Postponed (sine die) from 2017, legislative

Strengths

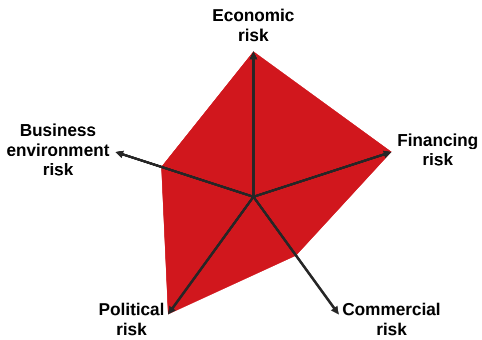
- Regional support from the GCC states
- There are more Lebanese domiciled overseas than in the country itself and this large diaspora provides a major source of funding
- Lebanese debt remains financially marketable and the country has been able to raise international financial support, in need
- Ownership of public debt is largely domestic, or with the diaspora
- Educated workforce
- Strong FX reserves and import cover

Weaknesses

- Tensions between the religious factions spill over into the political arena and into periodic outbreaks of violence
- Regional factors, including events in Syria and Iraq and tensions arising directly and indirectly from Iranian influence
- Large fiscal deficits and high public debt (among the highest in the world when expressed as a percentage of GDP)
- Very large current account deficits
- A fixed exchange rate (the LBP is pegged to the USD) prevents economic management through that mechanism
- Relatively poor data provision

Country Rating

D4



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Saudi Arabia	10%	1	12%	China
United Arab Emirates	10%	2	7%	Italy
Switzerland	8%	3	6%	United States
Syrian Arab Republic	8%	4	6%	France
Iraq	6%	5	6%	Germany

By product (% of total)

Exports		Rank		Imports
Gold, non-monetary	10%	1	17%	Petroleum & products thereof
Vegetables and fruits	9%	2	9%	Road vehicles
Metalliferous ores and metal scrap	7%	3	5%	Medicinal & pharmaceutical prod.
Non metallic mineral manufactures	6%	4	4%	Non metallic mineral manufactures
Power generating machinery & eq.	5%	5	3%	Iron and steel

Source: UNCTAD (2015)

Lebanon exhibits structural weaknesses and is highly vulnerable to the unstable regional environment

The Lebanese economy is highly dollarized and essentially service-oriented (services account for over 80% of GDP, compared with around 15% for industry and 4% for agriculture). It is exposed to regional and global fluctuations. Tourism, real estate, and construction are the main supply-side drivers of growth, which have taken a toll since the beginning of the Syrian conflict in 2011. The conflict has continuously spilled over to the economy as Lebanon today hosts the highest number of refugees per capita in the world (more than a quarter of the population). It has significantly increased labor supply (+50% between 2011 and 2014 according to the IMF) and strained Lebanese public services.

Yet, Lebanon enjoys financial stability due to important flows of remittances from the large diaspora (USD7.2bn in 2015, 14% of GDP, and USD6.6bn in 2016). Even though those flows strengthen the deposits of private banks that hold assets worth over 350% of GDP, the banking sector presents vulnerabilities. In fact, the non-performing loans to total loans ratio stands at 10.4% according to the IMF and has more than doubled in three years.

GDP growth should accelerate but remains contingent on developments in Syria

GDP growth accelerated slightly in 2016 (+1.0%, up from +0.8% in 2015) as consumer confidence improved with the election of President Michael Aoun in October 2016, after the presidential post had been vacant for two and half years. Private consumption remains the main growth driver, while weak export performance due to the closure of trade routes in Syria still drags growth down. In 2017, growth should accelerate to +2% as political uncertainty is reduced; yet, it should remain lower than the past 10-year trend of +3.3% due to regional instability stemming from the ongoing Syrian civil war and tax increases. In addition, this acceleration should only moderately create jobs for the Lebanese; the World Bank estimated the long-run employment-growth elasticity in Lebanon to be 0.2 against a 0.5 average for the MENA region according to the IMF.

Deflationary pressures reflecting low commodity prices, an appreciating exchange rate due to the USD peg and subdued activity are over. Indeed, after a -3.7% deflation in 2015, prices decreased less in 2016 (-0.8%) and are expected to pick up in 2017, along with activity.

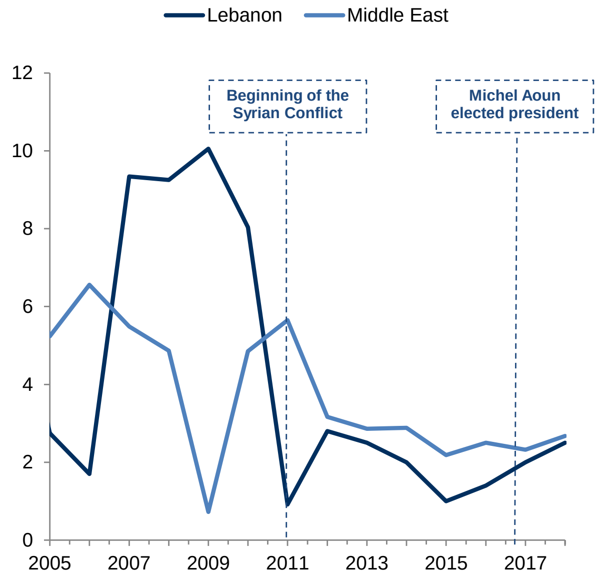
The higher inflation has mainly been driven by the recovery of the real estate sector and by clothing, footwear, and education. In 2016, the central bank (*Banque du Liban* or BdL) has maintained an expansionary policy to support demand and investment in an environment of deflationary pressures and growth lower than potential. Monetary policy should remain accommodative after the BdL extended its loan subsidy program, mainly benefiting the real estate sector.

Key economic forecasts

	2015	2016	2017f	2018f
GDP growth (% change)	0.8	1.0	2.0	2.5
Inflation (%, end-year)	-3.7	-0.8	4.0	2.5
Fiscal balance (% of GDP)	-7.4	-9.5	-9.0	-8.0
Public debt (% of GDP)	138.4	144.0	146.0	147.0
Current account (% of GDP)	-18.4	-16.0	-18.0	-17.0
External debt (% of GDP)	62.7	64.0	65.0	64.0

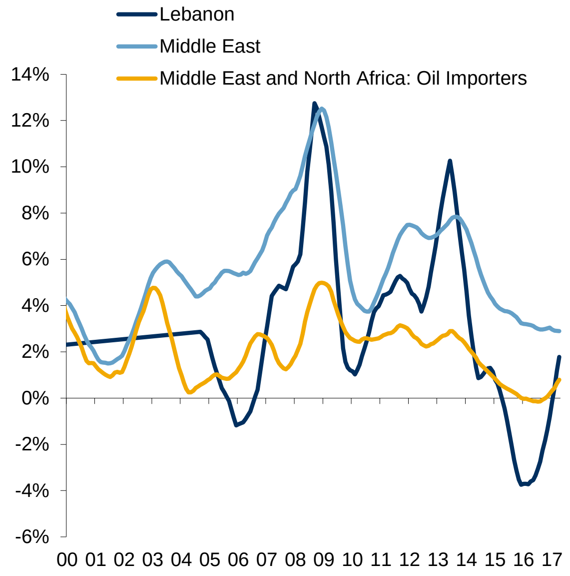
Sources: National statistics, IHS, Euler Hermes

Real GDP growth (% y/y)



Sources: National statistics, IHS, Euler Hermes

Inflation (% y/y)



Sources: National statistics, IMF, Euler Hermes

Domestic political stabilization is encouraging…

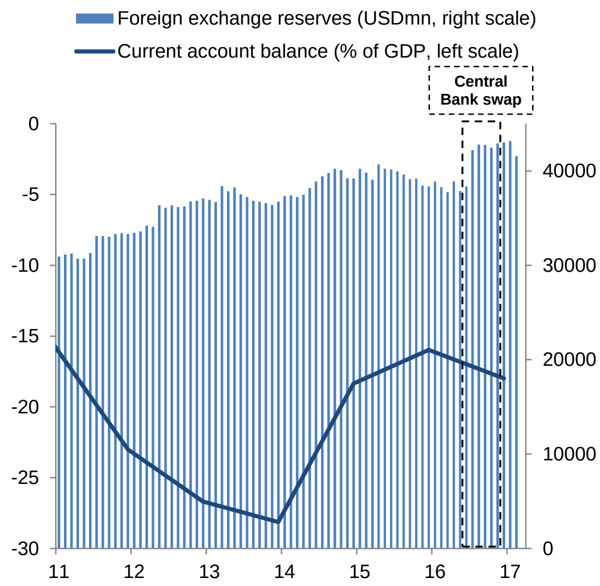
The World Economic Forum's global competitiveness index underlines the lack of trust of Lebanese people in their politicians (Lebanon ranks 125th out of 144 countries) and persistent transparency issues (Lebanon ranks 135th). Yet, there might be signs of improvement in the political environment. In January, the Council of Ministers approved the first decrees authorizing offshore gas exploration in Lebanon's Exclusive Economic Zone. Two months later, the parliament ratified the first formal budget since 2005. Although it adopted tax increases without addressing structural reforms, it sent a signal of political stabilization.

…but the new government faces tough public finances and external balance challenges

The new government has yet to tackle a high and deteriorating public debt to GDP ratio (estimated at 144% in 2016 and 146% in 2017) and large twin deficits. The current account deficit (-16% in 2016) makes Lebanon highly dependent on inward capital flows. Yet its important foreign exchange reserves (covering more than a year of imports) are a strength. The central bank recently increased reserves through a swap, to reinforce investors' confidence. External debt stood at 64% of GDP in 2016 but reaches as high as 217% if we include short-term nonresident deposits, which are more volatile.

The authorities' efforts should be supplemented by the European Bank for Reconstruction and Development's (EBRD) funding for projects, as Lebanon will become its 66th member. The EBRD is likely to establish a permanent office in Beirut. Priorities will be: fostering private sector competitiveness and sustainable supply of energy, enhancing public services and infrastructures and helping the country tackle the refugee crisis.

Foreign exchange reserves and current account balance



Sources: National statistics, IMF, Euler Hermes

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