



LEBANON: CHALLENGES OF A POLITICAL SHIFT

Cabinet will likely be formed within two weeks; however many economic and political challenges have to be tackled

Economic activity affected by the current political stalemate; however growth is expected to catch up over the year

The exchange rate peg remains solid and the banking system is sound and profitable

February 10, 2011

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[A new Prime Minister emerges after the collapse of the Unity government](#)

In the immediate afterward of the collapse of Lebanon's national unity government on January 12, Najib Mikati, backed by the opposition, presented and won his candidature as a prime minister on January 25. Mikati served previously as Lebanon's Prime Minister for a short period of three months in 2005, following Rafik Hariri's assassination. He is a billionaire businessman at the core, and moved to the public scene in 1998 as a Minister of Public Works and Transportation, and joined the parliament in 2000 and 2009. In addition, he enjoys good relations with countries in the region and with western democracies.

While Mikati's victory is viewed by the Future movement block as a triumph for March 8 alliance, the opposition considers him a neutral figure with a moderate stance. Mikati himself, asserted to be a consensus candidate and aims to form a cabinet that includes all parties, but Hariri's coalition is still rejecting to participate. If ongoing consultations do not convince the March 14 coalition to take part in the new government, Mikati will likely form a cabinet from the March 8 block along with independent and technocrats' figures. It is expected that the cabinet will be formed within the next 2 weeks.

[The new cabinet will face challenges](#)

Mikati's future cabinet will have to address the economic and political reforms, a highly challenging task for the newly elected Prime Minister. On the economic front, the government should propose the needed structural reforms, including infrastructure, telecommunications, energy with a focus on Electricity du Liban (EdL), water, education, and health sectors. On the political front, the new government will have to address issues related to the UN-backed tribunal such as false witnesses and funding of the tribunal.

The address of the economic challenges may be postponed as a consequence of the hurdles preventing the immediate parliamentary approval of the 2011 budget. Consequently, while the delay in addressing the structural reforms will threaten the long-term growth potential of Lebanon, the deficit will be restraint over the near-term, resulting in a widening of the primary surplus and possibly, a decline in the ratio of debt-to-GDP. However, even if by any chance the process for approving the budget of 2011 by the parliament is accelerated, it will not take place before May 2011.

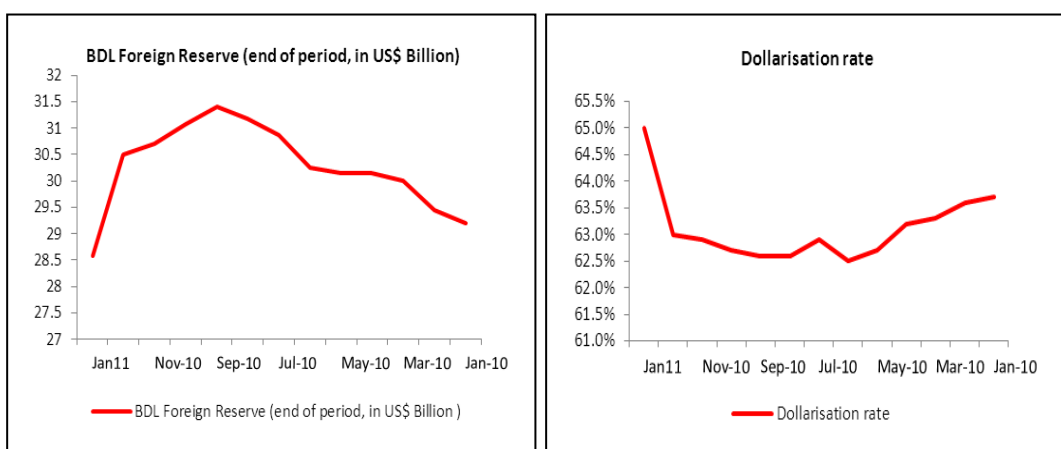
The economic environment is set to improve

Lebanon’s economic activity will surely be affected by the present political stalemate; however, we believe the economy to catch up in the coming weeks and continue to perform strongly with minimal implications on its growth. The current political deadlock might weigh down on foreign direct investment and the tourism sector, but we do not expect the situation to last long. Economic order will be achieved, giving room for economic growth to accelerate over the year.

The banking system will remain sound and profitable despite the current tensions. Depositors will remain highly motivated by a strong trust and confidence in Lebanon’s banking system, as it has been the case during several previous periods of political and economic fragility that revealed more accentuated than the current one. Growth in deposits might risk a slowdown but only moderately, helping banks insure enough liquidity to meet the private sector’s need, and ensure the sustainability of the public debt that requires deposits to grow by at least 4% a year.

The peg is solid but CDS have increased

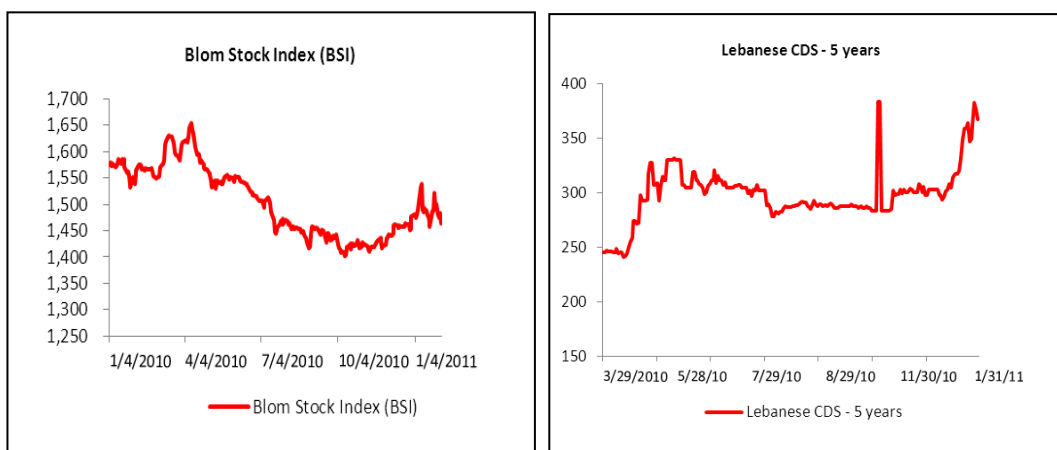
The peg of the Lebanese pound (LP) to the dollar will be preserved with Central Bank’s entrusted capability to defend the exchange rate from any negative pressure that may emerge. The Lebanese pound remains within the band of the peg but has been trading at the higher end of [LP 1510.5; LP 1514.5] since November. The rise has been driven by shifts in deposits from LP to US dollar that peaked around the consultations period to nominate the prime minister and smoothed down afterwards, most likely driven by the improvement in investors’ sentiment towards the outcome of these consultations. Dollarisation rate rose consequently from 63% to 65% in January, still below the 75% recorded in August 2006. We believe that the current situation can be easily handled through the substantial level of foreign reserves held at the Central bank, estimated at \$30.4 billion as of January 31st.



Source: Banque du Liban

Bond Markets responded unfavorably to the political upheaval with the Blom Bond Index (BBI) falling by nearly 2.1% in January. Credit Default Swap (CDS) spreads on Lebanese debt widened from 305 bp on January 11 to 360 bp on February 9.

Following the collapse of the government, the Beirut Stock Exchange market experienced high volatility but the overall underlying trend seemed downward with the Beirut Stock index (BSI) falling by 3.6% since January 11, and the average volume traded dropping 60.8%. Shares in Solidere A and B closed at \$19.3 and \$19.25 respectively on February 2nd, recording a decline of 5.4% in Solidere A and 4.1% in Solidere B since January 11. The banking sector has also been on the downfall with Audi GDR and Blom GDR down 10.3% and 6.2% respectively to \$8.0 and \$10.14. "The day following the appointment of Mikati as a Prime Minister witnessed a surprising 2.2% rise in the Beirut Stock index (BSI), possibly reflecting confidence in the upcoming phase.



Source: Bloomberg

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