ISSUER COMMENT
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Government of Lebanon

Conflict's spread to Lebanon exacerbates economic, financial and social crisis

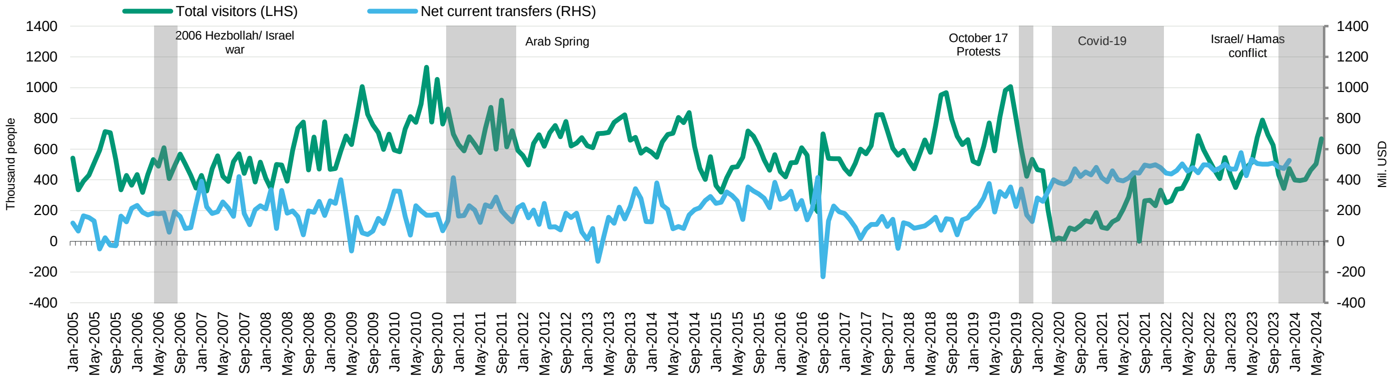
On 2 October, Israel (Baa1 negative) stepped up its strategy of 'targeted escalation' in Lebanon (C stable) following two weeks of Israeli airstrikes on Hezbollah targets in Lebanon. The unfolding conflict within Lebanon's own territory compounds an already very bleak credit picture and undermines the Lebanese government's efforts to stabilize the economy through increased dollarization. The conflict's population displacement will exacerbate weaknesses in the country's already stressed health and social conditions. Also, a degradation of infrastructure and public services further undermines any prospect of economic recovery in the near term.

Since defaulting on eurobond payments in March 2020, the government has lost access to key external funding sources and capital markets, and the domestic currency has largely lost its value as means of exchange. As a result, both public and private sectors have become increasingly dollarized, with remittances from Lebanese expatriates and tourism the main sources of foreign exchange revenue. Lebanon's dollarization trend has contributed to relative exchange rate and price stability over the past year. At the same time, the government reduced its deficit spending so that it can operate with the revenue generated in foreign currency, including to make salary payments.

Tourism is a key source of foreign exchange (FX) revenue in Lebanon comprising almost 20% of GDP in 2023, according to the Banque du Liban. Historically, Lebanon's tourism inflows have tended to rebound after periods of instability, although the significant damage to transport and physical infrastructure is likely to have a lingering effect. Tourist visits are mainly expatriates residing in other Arab countries and Middle East North Africa region nationals (representing over 80% of total foreign visitor arrivals in recent years). The country's instability is less likely to deter them (see Exhibit 1), than visitors from the rest of the world.

However, we expect disrupted tourism on the heels of the pandemic to significantly weigh on this key source of FX revenue, on which the entire economy has come to rely. An equally key source of FX revenue is workers' remittance inflows, also comprising about 20% of GDP. Remittance inflows have remained resilient in the post-pandemic period, but are likely to be temporarily disrupted, similar to trends observed during previous conflicts.

Exhibit 1
Tourist arrivals and remittances in Lebanon have historically rebounded from shocks (monthly data)



Sources: Central administration of statistics, Banque du Liban and Moody's Ratings

According to the United Nations, at least 346,000 people have been internally displaced and plans are underway to shelter up to 1 million IDPs. The influx of internally displaced persons into urban areas strains housing, healthcare and education systems, leading to overcrowding and a decline in the quality of social services such as social assistance, insurance, welfare and employment opportunities for the most vulnerable. And, critical infrastructure such as roads, bridges and utilities are at risk of damage or destruction, hindering the country's ability to provide essential services and support economic recovery. The conflict will exacerbate the already low quality of basic public services in the water, electricity, transport, health, education and social protection sectors. If extended, the conflict's effect on Lebanon's infrastructure would be substantial, requiring significant investment and international aid to rebuild and restore functionality.

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