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Research Update:

Republic of Lebanon Downgraded To 'B-' On Deteriorating Fundamentals And Rising Political Risks; Outlook Still Negative

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Overview

- The Syrian civil war has led to a steady deterioration of Lebanon's macroeconomic fundamentals, including its fiscal balances and growth prospects.
- Political risk in Lebanon has also risen; there has been no government in place for over six months and sectarian tensions are rising, fuelled by the spill-over from Syria.
- We are therefore lowering our long-term foreign and local currency ratings on Lebanon to 'B-' from 'B'.
- The outlook remains negative, reflecting our view that we could lower the ratings on Lebanon if the Syrian civil war further undermines its debt-servicing capacity.

Rating Action

On Nov. 1, 2013, Standard & Poor's Ratings Services lowered its long-term foreign and local currency sovereign credit ratings on the Republic of Lebanon from 'B' to 'B-'. At the same time, we affirmed the short-term ratings at 'B'. The outlook remains negative.

Rationale

The downgrade reflects our assessment that Lebanon's macroeconomic fundamentals have slowly but steadily declined since the Syrian crisis began in early 2011. After nearly three years of weak growth--exacerbated by an internal political environment not conducive to policymaking--public finances have deteriorated and the debt-to-GDP ratio is again trending upward.

The security situation has worsened; violence peaked over the summer following Hizbollah's direct involvement in Syria. Violence continues in tense border areas. The influx of Syrian refugees, which now make up an estimated one quarter of Lebanon's population, will strain the country's resources and public finances while potentially destabilizing Lebanon's demographic balance. The ratings are still supported by Lebanon's banks, which finance the government's borrowing requirements and which, in turn, benefit from steady deposit inflows and cash reserves.

More than six months after the resignation of the Mikati government, the new

prime minister designate, Tammam Salam, has yet to form a government, leaving former prime minister Najib Mikati in charge of a caretaker government. Lebanon has previously gone without a fully empowered government for extended periods, most recently in 2011.

Even if a fully sanctioned government were in place, we would still view Lebanese policymaking as constrained. This reflects its divisive political environment, which is accentuated by the regional crisis. Sectarian tensions in Lebanon have steadily increased since the start of the crisis in Syria and spiked over the summer following Hizbollah's public acknowledgement that it was lending military support to the Assad regime. The escalation of violence in Syria, however, has not led Lebanon into a renewed civil war of its own. We believe such an outcome is unlikely because of the strength of Hizbollah's militia and its domestic political goals, the professionalism of the Lebanese military, and the continued constructive efforts of the leaders of the various sectarian groups to ensure a degree of stability.

The Syrian crisis has displaced millions of people. Lebanon has been affected far more than any neighboring state. Over 700,000 refugees have registered in Lebanon, according to the United Nations High Commissioner for Refugees (UNHCR), but it is estimated that one million Syrians have crossed the border into Lebanon. This figure, which will continue to grow, represents one quarter of Lebanon's population. The influx of refugees is severely straining Lebanon's infrastructure and public finances, and it is exacerbating its already complicated sectarian and religious divisions.

Economic growth remains weak, with the conflict in Syria continuing to depress all potential growth drivers for Lebanon, including tourism, trade, and investment. We forecast that Lebanon will grow at 2% or less through 2015. We do not, however, expect the economy to contract. Lebanon has proven its macroeconomic resilience in previous crises and we expect this will continue.

The crisis is hurting Lebanon's already structurally weak public finances. In 2013, we expect the deficit will widen to 9.5% of GDP. Revenue is depressed and expenditures have increased. This is mostly due to an increase in public-sector wages after a one-off cost-of-living adjustment in 2012, and increased pension costs due to the rising number of pensioners. Personnel cost accounts for more than one-third of expenditures and interest payments are about 40% of revenues. The deterioration in the primary balance highlights the lack of fiscal space; it moved into deficit in 2012 for the first time since 2006. We expect net general government debt to rise to 120% of GDP this year, from 116% at year-end 2012, and to reach 125% by 2015.

Confidence in the Lebanese banking system underpins Lebanon's sovereign creditworthiness. Despite the regional turbulence, this confidence remains intact--supported by remittances from the Lebanese diaspora and the interest rates banks pay on deposits. The banking system's funding profile features a high proportion of retail deposits. We expect the depositor base to remain resilient, as it has done in previous instances of acute turmoil. Banking sector deposits are around twice the level of government debt.

The banks support the government debt market in two ways. First, they buy Lebanese government debt directly. At Aug. 31, 2013, general government debt was 21% of total banking system assets. This means bank creditors held 55% of gross central government debt, equivalent to 74% of GDP. Second, Lebanese banks buy certificates of deposit issued by the Banque du Liban (the central bank or BdL), which in turn buys government debt. At Aug. 31, BdL certificates of deposit represent an estimated 32.5% of total banking system assets, equivalent to 123% of GDP. The BdL in turn held 32% of local currency government debt.

While slower than before the Syrian civil war, bank deposits have grown this year (to Aug. 31) by an annualized 7.7% (including resident private sector and nonresident deposits) and we expect this pace to continue. Given the weak economy, we believe that the growth of this source of funds is sufficient to meet much of the government's borrowing requirement without crowding out the private sector.

Lebanon's external position appears to have eased in 2013, although inconsistencies make interpreting the data difficult. The current account deficit narrowed to below 4% of GDP, according to official data, and we forecast that the deficit will narrow to 3% of GDP in 2013. It had averaged 16.6% of GDP, according to official data, during 2008-2011. We project that central bank reserves will end the year at more than \$40 billion, or 120% of short-term external debt, helping to maintain confidence in the central bank's long-standing peg to the U.S. dollar. We note that the financial sector became a net external debtor in 2011, that its share represents more than two-thirds of the country's gross external debt. The sector's ability to increase its reliance on external savings will be important for meeting Lebanon's external financing requirements.

Outlook

The negative outlook reflects our view that credit risks will remain significant while the Syria conflict remains unresolved. We could lower the ratings further if the political and economic situation deteriorates to the point where it stanches domestic deposit growth or external inflows to the banking system. Both are important sources for funding the government's fiscal deficits and external requirements as well as for maintaining confidence in the Lebanese pound's peg to the dollar.

The ratings could stabilize if there is a breakthrough on the domestic political front.

Key Statistics

Table 1

Republic of Lebanon - Selected Indicators											
	2006	2007	2008	2009	2010	2011	2012	2013e	2014f	2015f	2016f
Nominal GDP (US\$ bil)	22	25	29	35	38	40	42	44	47	49	53
GDP per capita (US\$)	5,343	5,937	6,888	8,274	8,756	8,950	9,262	9,540	9,825	10,169	10,680
Real GDP growth (%)	1.6	9.3	9.1	10.3	8.0	2.0	1.5	1.5	1.5	2.0	3.5
Real GDP per capita growth (%)	(0.8)	7.8	7.9	8.7	5.6	(1.1)	(0.5)	(0.5)	(0.5)	0.0	1.5
Change in general government debt/GDP (%)	8.7	6.8	17.4	11.6	3.8	2.6	9.5	9.5	9.0	9.0	8.0
General government balance/GDP (%)	(13.9)	(10.4)	(10.1)	(8.4)	(7.6)	(5.8)	(9.3)	(9.5)	(9.0)	(9.0)	(8.0)
General government debt/GDP (%)	185.2	171.0	163.2	145.6	138.4	133.9	136.3	139.3	141.6	143.1	141.6
Net general government debt/GDP (%)	171.7	158.8	144.1	125.7	118.5	115.7	116.1	120.0	123.2	125.7	125.4
General government interest expenditure/revenues (%)	62.3	56.5	47.0	45.5	46.5	40.2	38.5	39.4	40.7	40.7	40.1
Oth dc claims on resident non-govt. sector/GDP (%)	70.3	72.2	73.0	69.0	79.8	85.4	89.5	92.8	95.4	99.4	102.1
CPI growth (%)	5.6	9.3	5.5	3.4	4.6	3.5	4.0	4.0	5.0	4.0	4.0
Gross external financing needs/CARs +use. res (%)	114.4	111.6	118.3	110.5	101.4	91.9	89.5	88.4	88.9	90.6	92.0
Current account balance/GDP (%)	(5.1)	(6.5)	(14.4)	(20.0)	(19.9)	(12.1)	(3.9)	(3.1)	(3.2)	(4.9)	(6.6)
Current account balance/CARs (%)	(5.0)	(6.4)	(13.1)	(23.2)	(24.5)	(13.8)	(4.3)	(3.3)	(3.5)	(5.3)	(7.0)
Narrow net external debt/CARs (%)	(47.9)	(52.8)	(55.2)	(88.9)	(111.0)	(95.7)	(91.3)	(78.7)	(74.2)	(68.6)	(59.0)
Net external liabilities/CARs (%)	34.6	28.2	21.1	11.2	3.7	10.0	14.8	24.4	31.7	39.6	48.4

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts.

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Sovereign Defaults And Rating Transition Data, 2012 Update, March 29, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

In accordance with our relevant policies and procedures, the Rating Committee

was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts. The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook.

Ratings List

Downgraded; Ratings Affirmed

	To	From
Lebanon (Republic of)		
Sovereign Credit Rating	B-/Negative/B	B/Negative/B
Transfer & Convertibility Assessment	B+	BB-
Senior Unsecured	B-	B
Short-Term Debt	B	B

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