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Research Update:

Ratings On The Republic of Lebanon Affirmed At 'B-/B'; Outlook Stable

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Overview

- Deposit flows into Lebanon's banking system remain resilient and continue to facilitate the government's debt servicing capacity.
- Notwithstanding this, public finances are under pressure and the already-high government debt stock will continue to rise.
- We are affirming our 'B-/B' long- and short-term foreign and local currency sovereign credit ratings on Lebanon.
- The stable outlook reflects our view that deposit inflows to the financial system will enable the government to meet its financing needs over the coming year despite the difficult internal and external political environments.

Rating Action

On Oct. 10, 2014, Standard & Poor's Ratings Services affirmed its 'B-/B' long- and short-term foreign and local currency sovereign credit ratings on Lebanon. The outlook is stable.

Rationale

The government's debt servicing capacity is materially determined by the domestic financial sector's willingness and ability to continue buying government debt, directly or indirectly, and by the strength of deposit flows to the financial system. In our view, confidence in the Lebanese financial system remains strong and is not likely to be significantly affected by domestic political developments, short of a major escalation of local unrest.

The external and internal political and macroeconomic shocks that Lebanon has faced since early 2011--the ongoing crisis in Syria, the recent heightened security risks due to ISIS' territorial gains, lengthy periods without a government, and the current presidential vacuum--have not led to material deposit outflows. The banking system's funding profile features a high proportion of retail deposits that have shown resilience through various crises. Resident and nonresident private-sector deposit growth was 7.7% year-on-year as of end-July. In our view, this should be sufficient to enable the domestic financial sector to finance the large government deficit and demand for private-sector credit. That said, banking sector profitability has deteriorated.

We estimate general government debt will reach 144% of GDP this year. As of end-June, 60% of gross debt was denominated in local currency. Domestic banks support the government debt market directly and indirectly; firstly, they buy Lebanese government debt directly. At first-half 2014, general government debt accounted for 22% of total banking system assets. Bank creditors held 53% of the government's outstanding local currency debt. Secondly, Lebanese banks buy certificates of deposit issued by the Banque du Liban (the central bank or BdL), which in turn buys government debt. We view the concentration of government financing from these sources as a structural weakness that leaves Lebanon more vulnerable to adverse business, financial, and economic conditions. The BdL itself held 30% of local-currency government debt as of end-June. The bank keeps substantial foreign assets to maintain confidence in the system; gold ($11.9 billion) and foreign currencies ($35.1 billion) of $47 billion covered 33% of resident and nonresident private-sector deposits at the end of July.

The high reserves--together with large inflows of remittances, FDI, and foreign deposits--provide an important buffer for Lebanon's very large trade deficit. We consider that Lebanon's balance of payments, with its very large trade deficits, remains vulnerable in both the current and financial accounts. We acknowledge, however, that stock-flow discrepancies between the balance of payments and IIP mean that Lebanon's external position is relatively opaque. We estimate gross external financing needs at about 100% of current account receipts (CARs) and usable reserves. Under our definition of narrow net external debt, we estimate that liquid external assets will exceed external debt by 70% of CARs.

There has been a presidential vacuum since president Sleiman's term ended in May, because the parliament has failed to agree on a candidate. Under an unwritten agreement, the president must be from Lebanon's Maronite Christian community, the prime minister must be a Sunni Muslim, and the speaker of the parliament a Shia Muslim.

That said, there has been a "national interest" government in place since February this year, formed after 10 months of negotiations. It includes members of centrist parties, as well as both the March 14 and March 8 political alliances. The March 14 political alliance is led by former prime minister Hariri, who opposes the Assad regime in Syria. The March 8 alliance is led by Hezbollah, whose military arm is actively fighting in support of the Assad regime and whose involvement has led to reprisal attacks from Sunni militias increasingly operating on Lebanese territory. Despite some initial optimism regarding the government's policymaking capabilities under prime minister Tamam Salam, we expect policymaking to remain constrained by the divisive political environment. Institutional and governance effectiveness remains a key ratings weakness. We expect that the parliament--the term of which has already been extended by 18 months--will extend its term again rather than hold the elections due in November.

Economic activity remains depressed. Heightened security risks and rising concerns about the potential impact of ISIS operations in the region have likely offset most of the positive gains in consumer and business confidence in the first half of the year, which followed a relative stabilization of the security environment in the spring. We estimate average growth over 2012-2014 of 1.5%, noting, however, that national accounts statistics have not been published since 2011. Overall, we do not anticipate a significant rebound in tourism, financial and trade services, or FDI while the region remains unstable. We therefore do not foresee a material improvement in Lebanon's macroeconomic fundamentals or creditworthiness. This is despite the stability of deposits and stimulus package the BdL launched in 2013. The stimulus package, channeled mostly toward housing loans, totaled $1.4 billion last year and was extended by a further $800 million in 2014.

Public finances also remain weak. We anticipate the general government deficit will widen to 10% of GDP, and that a rise in current expenditure will be partly offset by a larger-than-expected transfer from the Ministry of Telecommunications this year. Fiscal space is severely limited; interest payments on debt are nearly 8.5% of GDP, or 40% of revenues, while transfers to the loss-making electricity company, Electricité du Liban (EdL), are 4% of GDP.

Our forecasts do not include a proposed salary-scale adjustment for the public sector, which would cost an estimated 2% of GDP. This has been debated by parliament for two years following a cost-of-living adjustment that pushed up the deficit by 3% of GDP in 2012, along with higher transfers to EdL and municipalities. We note that parliament has failed on several occasions to agree on offsetting revenue measures. The revenue measures under discussion focus on increasing various taxes, including VAT and income tax, which could put further pressure on the economy and the banking system.

Parliament has yet to ratify a new borrowing law in foreign currency; if it does not, increases in government external debt will be constrained. The limit was last lifted by $5 billion in 2012 to finance foreign currency treasury needs ($2 billion) and for debt refinancing ($3 billion), and has been fully utilized. If the limit is not lifted, the government can only refinance maturing foreign currency debt; we expect BDL to continue providing the government with additional foreign currency needs in exchange for local currency, should the need arise.

The political environment precludes Lebanon from receiving significant financial support from the international donor community, as does government policy against setting up refugee camps that would allow the donor community more direct access to aid refugees. The Syrian crisis has displaced millions of people, both internally and outside of the country. The UN High Commissioner for Refugees reports that the number of registered refugees in Lebanon has reached 1.3 million, increasing the population of Lebanon by about one-third. In the medium term, the Lebanese government will be increasingly occupied with addressing the effects of the growing refugee population on Lebanese politics and society, as well as on the economy, as pressures mount on public spending, services, infrastructure, and the labor market. We note that the government has been discussing possible solutions for hosting refugees in the border areas. The World Bank is managing a multi-donor trust fund aimed at supporting Lebanese communities hosting Syrian refugees, which has raised almost $30 million. The World Bank estimates that $1.3 billion is needed to help stabilize the impact of the influx of refugees on Lebanese infrastructure, public resources, and foregone revenues.

Outlook

The stable outlook reflects our view that deposit inflows into the financial system will continue over the coming year despite the difficult internal and external political environments, and that consequently the domestic financial sector will continue to enable the government to meet its financing needs.

If the political and economic situation deteriorates to the point where it staunches deposit growth, or if public finances deteriorate significantly, we could consider lowering the ratings.

We could consider raising the ratings if public finances became more sustainable, which would be supported either by a political breakthrough in Syria--potentially improving economic growth prospects in Lebanon--or an improvement in domestic policymaking that could translate into fiscal reforms.

Key Statistics

Table 1

Republic of Lebanon - Selected Indicators

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP (US$ bil)	25	29	35	38	40	43	45	47	49	52	56
GDP per capita (US$)	5,937	6,888	8,274	8,756	8,950	9,247	9,335	9,420	9,469	9,849	10,343
Real GDP growth (%)	9.4	9.1	10.3	8.0	2.0	2.5	1.5	1.5	1.5	2.5	3.5
Real GDP per capita growth (%)	7.8	7.9	8.7	5.6	(1.1)	(1.2)	(2.2)	(2.4)	(2.4)	0.5	1.5
Change in general government debt/GDP (%)	6.8	17.4	11.7	3.8	2.6	9.4	12.8	10.0	10.5	10.0	10.0
General government balance/GDP (%)	(10.4)	(10.1)	(8.4)	(7.6)	(5.8)	(9.1)	(9.4)	(10.0)	(10.5)	(10.0)	(10.0)
General government debt/GDP (%)	171.0	163.2	145.6	138.4	133.9	134.2	141.0	144.3	148.6	150.0	150.1
Net general government debt/GDP (%)	158.8	144.1	125.7	118.5	115.7	114.3	118.2	122.6	127.8	130.4	131.8
General government interest expenditure/revenues (%)	56.5	47.0	45.5	46.5	40.2	38.5	40.2	42.0	42.2	42.3	42.3
Oth dc claims on resident non-govt. sector/GDP (%)	72.2	73.1	69.0	79.8	85.4	88.1	92.2	94.9	98.9	104.4	109.2
CPI growth (%)	9.3	5.5	3.4	4.6	7.2	5.9	3.2	3.0	4.0	4.0	4.0
Gross external financing needs/CARs +use. res (%)	111.6	118.3	110.5	100.5	91.1	91.5	93.2	104.0	104.8	108.5	110.7
Current account balance/GDP (%)	(6.5)	(14.4)	(20.0)	(18.3)	(10.9)	(8.2)	(12.9)	(12.5)	(12.7)	(13.9)	(12.8)

Table 1

Republic of Lebanon - Selected Indicators (cont.)											
Current account balance/CARs (%)	(6.4)	(13.1)	(23.2)	(23.5)	(12.8)	(9.9)	(16.7)	(16.4)	(16.6)	(18.3)	(16.9)
Narrow net external debt/CARs (%)	(52.8)	(55.2)	(88.9)	(115.1)	(98.7)	(99.0)	(80.5)	(70.8)	(62.4)	(54.4)	(47.8)
Net external liabilities/CARs (%)	28.2	21.2	11.2	3.8	10.3	17.4	49.9	63.8	77.1	90.6	101.1

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.

Ratings Score Snapshot

Table 2

Republic of Lebanon - Ratings Score Snapshot	
Key Rating Factors	
Institutional and Governance Effectiveness	Weakness
Economic Structure and Growth	Neutral
External Liquidity and International Investment Position	Neutral
Fiscal Flexibility and Performance	Weakness
Debt Burden	Weakness
Monetary Flexibility	Weakness

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional and governance effectiveness; (ii) economic structure and growth prospects; (iii) external liquidity and international investment position; (iv) the average of government debt burden and fiscal flexibility and fiscal performance; and (v) monetary flexibility. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Government Rating Methodology And Assumptions," published on June 24, 2013, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 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

Related Research

- Sovereign Defaults And Rating Transition Data, 2013 Update, April 18, 2014

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 committee agreed that the key rating factors were unchanged.

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. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed

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

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