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November 26, 2010

Research Update:

Republic of Lebanon 'B/B' Long-And Short-Term Sovereign Credit Ratings Affirmed; Outlook Remains Positive

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Overview

- In our opinion, the Lebanese government's focus on the U.N.-backed Special International Tribunal has caused structural adjustment in Lebanon to slow significantly. Once this concludes, however, we expect progress on reforms to resume speed.
- We are therefore affirming the 'B/B' sovereign credit ratings on the Republic of Lebanon.
- The positive outlook reflects our view of Lebanon's ongoing commitment to fiscal adjustment.

Rating Action

On Nov. 26, 2010, Standard & Poor's Ratings Services affirmed its 'B/B' long- and short-term sovereign credit ratings on the Republic of Lebanon. The outlook remains positive. The transfer and convertibility (T&C) assessment remains 'BB-', and the recovery rating of '4' was affirmed.

Rationale

The affirmation reflects our view that the Lebanese government will likely continue to make slow but steady progress on structural adjustment. We believe that structural adjustment, together with stability, is vital to support sustained improvement in the fiscal deficit and to maintain confidence in the banking system in the medium-to-long term.

Nevertheless, the ratings are constrained by our view of Lebanon's high public debt burden, large external imbalances, and the risk of a breakdown of the current consensus in the government. A key source of political tension at present is the U.N. Special International Tribunal's investigation into the circumstances surrounding the assassination of Prime Minister Rafik Hariri in 2005. We expect that Hizbollah will remain engaged with the Tribunal, which should conclude its investigations in early 2011. However, we believe that there is a risk that allegations of its involvement in the late Prime Minister's death could ultimately cause Hizbollah to withdraw from the government. We believe that this would severely undermine prospects for sustainable growth and political stability.

We forecast that Lebanon's fiscal deficit will narrow to the equivalent of 7% of GDP this year, from 13.5% in 2006. This decrease results from higher

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revenues on the back of stronger economic growth, the restoration of the gasoline excise rate back to its pre-capped rate, limits on spending because of delays in the approval of the 2010 budget, and low interest rates reducing funding cost, relative to headway on structural reform, which is vital for long-term stability.

Legislation allowing for the restructuring of the energy sector--or more particularly the state-owned and loss-making electricity company Electricité du Liban--and oil and gas exploration, have been given approval by the Council of Ministers and the Parliament, but have yet to be fully implemented. Moreover, other key initiatives such as cuts in the electricity, export and wheat subsidies and efforts to streamline the budgetary process have yet to be enacted. Indeed, until the U.N.-sponsored Special International Tribunal concludes, it is difficult to see much progress on the reform front.

The ratings on Lebanon are supported by our view of its large and stable resident and nonresident depositor base, which allows its banking sector to cover the government's financing requirements. At around 130% of GDP, the public debt burden is among the highest in the world and a major constraint on fiscal flexibility. However, according to our estimates, it has been decreasing rapidly in recent years from 183% in 2005, on the back of declining deficits and rapid growth in GDP. At US$104 billion or 263% of GDP (according to our estimates), we believe that private sector bank deposits are more than adequate to roll-over the sector's large exposure to the government, as long as confidence in the banking sector persists. Lebanon's current account deficit, which stands at over 20% of GDP, remains in our view a source of vulnerability and we believe its financing will remain highly reliant on continued investor confidence over the medium term.

Outlook

The positive outlook reflects our view that Lebanon's political consensus will lead to much-needed structural reform. The ratings could improve should the government make continued progress with reducing its debt burden. In our view, the major challenge facing Prime Minister Saad al-Hariri is maintaining working consensus among opposing factions in his new government in the face of the U.N. Special International Tribunal investigations. Conversely, the ratings could come under downward pressure if there is any outbreak of prolonged civil unrest, Hizbollah withdraws from the government, or if the working consensus within the government collapses.

Related Criteria And Research

- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009
- Rating Sovereign-Guaranteed Debt, April 6, 2009
- Sovereign Credit Ratings: A Primer, May 29, 2008

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- Introduction Of Sovereign Recovery Ratings, June 14, 2007

Ratings List

Ratings Affirmed

Lebanon (Republic of)	
Sovereign Credit Rating	B/Positive/B
Transfer & Convertibility Assessment	
Local Currency	BB-
Senior Unsecured	B
Recovery Rating	4
Short-Term Debt	B

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Complete ratings information is available to RatingsDirect subscribers on the Global Credit Portal at www.globalcreditportal.com and RatingsDirect subscribers at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4011.

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