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**Research Update:**

# Republic of Lebanon 'B-/C' Ratings Affirmed; Outlook Remains Negative

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## Research Update:

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## Rationale

On Sept. 20, 2007, Standard & Poor's Ratings Services affirmed its 'B-' long-term and 'C' short-term foreign and local currency sovereign ratings on the Republic of Lebanon. The outlook remains negative. At the same time, Standard & Poor's affirmed its 'B+' transfer and convertibility assessment on Lebanon.

The ratings on Lebanon reflect substantial political difficulties that have raised pressure on already precarious public finances. The government estimates that the destruction and dislocation caused by the mid-2006 conflict between Hizbollah and Israel will add a cumulative \$4.5 billion to the fiscal deficits over 2006-2010. Standard & Poor's estimates the general government deficit at 11.6% of GDP in 2007, and expects the debt stock to widen to 173% of GDP by end-year 2007.

Potentially of greater significance for Lebanon's creditworthiness, the war has led to a domestic political impasse and heightened uncertainties: Since late 2006, a confrontation between the Hizbollah-led opposition coalition and the ruling coalition has impeded policy-making and heightened social and political tensions in the country. Tensions have been exacerbated by sporadic violence, of which the assassination of MP Antoine Ghanem on September 19 is the latest example. The election of a new president--due by November 22 when the incumbent Emile Lahoud's term in office expires--will inevitably bring this confrontation to a head, with great uncertainty surrounding the outcome. One possibility is the creation of two parallel Lebanese governments. Although this remains unlikely, the presidential crisis does pose a serious threat to political stability and policy-making at a time when economic and financial challenges will require skillful management. It is crucial that the government meet its near-term policy targets, including the privatization of two mobile phone networks in 2008, to put public finances on a more sustainable path.

The ratings are supported, however, by the determination of major powers within the region and beyond to shore up the government of Fouad Siniora. In early 2007, at the so-called "Paris III" conference, the U.S., France, and Gulf Arab states committed \$7.6 billion in grants and concessionary loans to Lebanon. This will alleviate debt-servicing pressures, although less than \$2 billion was initially pledged for direct budgetary support and some of the funds were made conditional on policy measures. Lebanon's decision to request formal advice from the IMF, in the form of an Emergency Post Conflict Assistance program, also provides an important anchor, and budget performance for the first half of 2007 has been better than programmed. Moreover, the resilience of depositors in Lebanon's financial sector--with total assets amounting to 3.2x GDP--also supports Lebanon's capacity to meet its debt-servicing obligations.

## Outlook

A revision of the outlook to stable depends on Lebanon emerging from the presidential elections with the key institutions--cabinet, president and parliament--willing and able to advance the program of economic reform promised at Paris III. This in turn may require the active engagement and support of a range of international actors.

Conversely, the following developments could yet trigger a downgrade in the near term: the establishment of parallel governments, following failure to compromise over the presidency, which would raise major concerns over policy-making, and could point toward instability; or a violent incident, such as an assassination of a senior politician, that prompts an outflow of deposits from the crucial banking sector. Over the longer term, failure to resolve the current policy-making stasis could complicate the roll-over of debt, raise borrowing costs, and slow the release of Paris III funds leaving Lebanon increasingly reliant on additional support from donors. This could also trigger a downgrade.

## Ratings List

Foreign currency sovereign credit ratings

B-/Negative/C

Local currency sovereign credit ratings

B-/Negative/C

Transfer and convertibility assessment

B+

NB: This list does not include all ratings affected.

### **Additional Contact:**

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