# Fitch Upgrades Lebanon to 'B'; Outlook Stable

Fitch Ratings-London-31 March 2010: Fitch Ratings has today upgraded Lebanon's Long-term foreign and local currency Issuer Default Ratings (IDRs) to 'B' from 'B-'. The Outlooks on both ratings are Stable. Fitch has also upgraded Lebanon's Country Ceiling to 'B' from 'B-' and affirmed its Short-term foreign currency IDR at 'B'.

"The upgrade reflects the significant decline in Lebanon's public debt to 148% of GDP in 2009 from 180% in 2006, the favourable prospects for growth following improvements in the regional political and security situation, and the authorities' success in maintaining macroeconomic stability through multiple stress tests since 2005," says Purvi Harlalka, Associate Director in Fitch's Sovereign Rating Group.

Lebanon's rating is also underpinned by the size and depth of the local banking sector (350% of GDP in 2009), which is the main holder of Lebanese government paper (60% of the stock) and allows the government to sustain a higher level of debt than conventional indicators would suggest. The banking system's willingness and ability to finance the government is testament to the resilience of its non-resident deposit base, due partly to a strong home bias but also to conservative supervision and cautious interest rate management. Sustained deposit inflows are critical to the rating, given the domestic savings deficit, as they buoy growth and support the public finances.

Renewed confidence, spurred by the resolution of the domestic political impasse and the return of a functioning government, saw non-resident deposits rise by 23% last year, sustaining output growth at a rapid 8% in 2009. Given that the current political entente appears sustainable in the short-term, Fitch expects capital flows to remain high during 2010 and output to continue expanding robustly, although at a more moderate 6.5% pace this year. Together with the revival in tourism (arrivals reached a record 1.8m in 2009), these inflows should also continue to add to Lebanon's foreign exchange reserves (FXR) excluding gold, which rose to an unprecedented USD26bn (75% of GDP) in 2009 from USD17bn in 2008 (57% of GDP).

The substantial stock of FXR means that the Lebanese public sector was a net external creditor (on a residency basis) to the tune of 58% of GDP in 2009, while the public sector in the average 'B' range sovereign was a net external debtor to the extent of 14% of GDP. The accumulation of sizeable international reserves has also served to strengthen the credibility of the exchange rate peg, which is vital to the stability of Lebanon's financial and monetary systems given the high, albeit falling, rate of dollarization (64% in 2009).

The Stable Outlook reflects Fitch's forecast that the public debt ratio is likely to stabilise at current levels. The agency understands that the 2010 budget, which when passed will be the first approved budget since 2005, will be slightly expansionary, given the need to increase infrastructure spending. As capital expenditure has been restrained to the budgetary levels legislated in 2005, this rise is long overdue. It is to be accompanied by revenue raising measures, including a possible increase in VAT.

However, while spending growth is likely to outpace that of revenues, the authorities intend to maintain a small primary surplus to prevent any deterioration in debt dynamics. As a result, Fitch expects the general government deficit to widen to 10.7% of GDP in 2010 from 9.1% of GDP in 2009, but the debt ratio to remain constant at about 148% of GDP. Nevertheless, this will remain the second-highest ratio amongst Fitch-rated sovereigns, after Japan, and indebtedness is unlikely to fall significantly further over the medium term in the absence of long-mooted measures, notably the privatisation of Lebanon's lucrative telecoms business and the reining in of the electricity company EDL's deficit. Achieving either of these structural reforms remains politically challenging. As a result, Lebanon's substantial debt burden, which consumes about 45% of government revenues in interest service and leaves the republic vulnerable to growth and interest rate shocks, will continue to restrain its rating.

Lebanon's rating is also constrained by its susceptibility to regional and domestic political tensions which renders the sovereign's longer-term growth prospects and reform outlook uncertain. However, Lebanon's high per capita income, liberal business environment, and unblemished debt service record provide important support to its creditworthiness.

Applicable criteria, 'Sovereign Rating Methodology' dated October 16, 2009, are available on Fitch's website at www.fitchratings.com

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