FitchRatings

FITCH AFFIRMS LEBANON AT 'B'; OUTLOOK STABLE

Fitch Ratings-London-05 July 2011: Fitch Ratings has affirmed Lebanon's Long-term foreign and local currency Issuer Default Ratings (IDR) at 'B' and Short-term foreign currency IDR at 'B'. The agency has simultaneously affirmed the Country Ceiling at 'B'. The Outlook is Stable.

"The affirmation of Lebanon's ratings reflect the fact that its substantial foreign exchange reserve buffers, lower debt levels, and reduced interest costs, relative to the previous decade, mitigate the downside risks to political stability, growth and public finances in 2011," says Purvi Harlalka, Director in Fitch's Middle East and Africa Sovereign Ratings Group. "The already low rating embodies a measure of tolerance for political volatility. However, an outbreak of violent conflict resulting from either internal political strife or a spill over of tensions from neighbouring Syria could put the rating under negative pressure."

Output rose briskly (7%) in 2010, fuelled by rising non-resident deposits (up 11.5%), record numbers of tourist arrivals (2.2 million, up 17% from 2009) and a robust property market. The inflows continued to push down interest rates and dollarisation and drive up private credit growth to 24% - the highest rate in the Middle East. They also shored up the balance of payments to a surplus of USD3.5bn, causing Lebanon's stock of foreign exchange reserves to reach an all-time high of USD42bn (including gold).

However, the collapse of the national unity government in January and the wave of Arab uprisings caused a drop in confidence. The growth in non-resident private deposit inflows, which are a key driver of activity, slowed to 14% y-o-y in Q111, from 34%. Nevertheless, this slowdown comes off a high base (USD18.5bn at end 2010). Meanwhile tourism (-13.4% y-o-y) and property sales also declined significantly in Q111 and dollarisation increased slightly to 66.2% in April, from 63.2% in December 2010. Together with high oil prices, these trends led to a quarterly balance of payments deficit (USD400m in Q111).

As a result, the growth outlook for 2011 has deteriorated to 2.5%, as per Fitch estimates, from the 7%-8% of 2008-2010. The deteriorating situation in Syria also bodes ill for economic prospects, given its potential to further impact confidence. Although Lebanon's direct exposure to Syria is small (only 5.6% of Lebanon's exports and 1.9% of its imports went to/came from Syria in 2010), a lot of its goods exports are transported through Syria. However, the formation of a new coalition government in June, under the leadership of Najib Mikati, a business-friendly politician, restores some stability and could improve the economic and fiscal outlook for H211.

On current trends, a cut in gasoline taxes (0.7% of GDP), slowing consumption and investment and an increase in spending on public wages and roadwork means that the fiscal deficit is likely to widen to between 9%-10% of GDP in 2011 from 8% in 2010. Despite this, Fitch expects debt to stabilise below 135% of GDP in 2011 where it would nevertheless remain the third-highest of all Fitch-rated sovereigns after Japan and Greece. General government debt fell to 137% of GDP in 2010 from 179% in 2006.

A sustained reduction in sovereign debt brought about by strong growth and fiscal discipline would improve Lebanon's creditworthiness. By contrast, a sustained increase in debt would cause the rating to be lowered.

Debt sustainability is supported by the size and depth of the local banking sector (3.35x GDP in 2010), which is the main holder of Lebanese paper (56% of the total outstanding by end-2010). The resilience of this investor base, which mediates the funds repatriated by the wealthy Lebanese diaspora into the economy and government debt, underpins the stability of public finances and is vital to the rating.

As a result, the risk of sustained deposit flight prompted by political instability is the primary risk to Lebanon's rating. Although deposit flight is not unprecedented during periods of turbulence, such as in the wake of the Hariri assassination in 2005 and the war with Israel in 2006, it is usually temporary and deposit inflows tend to return quite quickly. On the domestic front, the refusal by Hezbollah, which has two ministers in the current coalition government, to arrest the individuals named in the indictment issued by the Special Tribunal for Lebanon, which is investigating the Hariri assassination, could inflame domestic tensions and curtail government effectiveness. Meanwhile, the worsening of the unrest in Syria could adversely affect Lebanon. Fitch's base case does not envisage the outbreak of sustained episodes of violence but such an outcome would adversely affect the rating.

Lebanon's high per capita income, liberal business environment, and the credibility of its exchange rate regime support its creditworthiness. The latter is especially relevant in the context of the high rates of dollarisation and Lebanon's vulnerability to political and external shocks.

Contact:

Primary Analyst
Purvi Harlalka
Director
+44 20 3530 1162
Fitch Ratings Limited
30 North Colonnade
London, E14 5GN

Secondary Analyst
Douglas Renwick
Director
+44 20 3530 1045

Committee Chairperson
Ed Parker
Managing Director
+44 20 3530 1046

Media Relations: Peter Fitzpatrick, London, Tel: +44 20 3530 1103, Email: peter.fitzpatrick@fitchratings.com.

Additional information is available at www.fitchratings.com.

Applicable criteria, 'Sovereign Rating Methodology', dated 13 August 2010, are available at www.fitchratings.com.

Applicable Criteria and Related Research:
Sovereign Rating Methodology
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=547765
Global Economic Outlook: Soft Patch in Global Recovery
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=640529
Sovereign Review and Outlook
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=642230

INTEREST, AFFILIATE FIREWALL, COMPLIANCE AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE 'CODE OF CONDUCT' SECTION OF THIS SITE.