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Research Update:

Lebanon Outlook Revised To Stable On Strength Of Financial System And Steady Deposit Inflows; Ratings Affirmed

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Overview

- In our view, Lebanon's government debt servicing capacity is supported by deposit flows to the financial system, which remain stable despite a challenging political and security environment.
- The formation of a new government, which now brings together rival political groups, reduces the risk of a widespread escalation of domestic conflict.
- On the other hand, we see little prospect for significant improvement in macroeconomic fundamentals or public finances, and we believe security risks will continue to weigh heavily on stability and growth.
- We are revising our outlook on Lebanon to stable from negative.
- We are affirming our 'B-/B' long- and short-term foreign and local currency sovereign ratings.
- 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 April 11, 2014, Standard & Poor's Ratings Services revised its outlook on the Republic of Lebanon to stable from negative. At the same time, we affirmed our 'B-/B' long- and short-term foreign and local currency sovereign credit ratings.

Rationale

The outlook revision reflects our view that the government's debt servicing capacity is materially determined by the strength of deposit flows to the financial system. In our view, this funding source has helped stabilize the government's financing needs during increasingly challenging times for the internal and external political environments. We note that deposit inflows have been stable, even during the domestic political vacuum in 2013 and also in the face of the increasing spillover from the deteriorating situation in Syria.

However, this concentration of government financing from a single source is also a structural weakness, which in our view leaves Lebanon more vulnerable to adverse business, financial, and economic conditions. In our opinion, the government currently has the capacity to meet its financial commitments.

Further, the formation of a government in February 2014, after nearly one year of negotiations, and which includes rival political groups, decreases the risk of renewed civil war in Lebanon.

Confidence in the Lebanese banking system underpins Lebanon's sovereign creditworthiness. Despite regional turbulence, this confidence remains intact and supported by remittances from the Lebanese diaspora and the interest rates banks pay on both local- and foreign-currency deposits. The banking system's funding profile features a high proportion of retail deposits, and banking sector deposits--including resident and nonresident deposits--were 2.1x government debt levels as of the end of February.

The banks support the government debt market in two ways. First, they buy Lebanese government debt directly. On Jan. 31, 2014, general government debt was 23% of total banking system assets. This means bank creditors held 53% of gross central government debt. Second, Lebanese banks buy certificates of deposit issued by the Banque du Liban (the central bank or BdL), which in turn buys government debt. The BdL itself held 30% of local-currency government debt on Jan. 31. The BdL keeps substantial foreign assets, with gold and foreign currencies of $45.6 billion covering 33% of resident and nonresident private-sector deposits at the end of February, to maintain confidence in the system.

The Syrian crisis has entered into its fourth year without a clear resolution in sight, and Lebanon's political, security, and economic trajectories will remain deeply entwined with developments in its larger neighbor. While we see little short-term prospects for a resolution to the Syrian crisis, we do not expect the political environment to deteriorate so badly that it would put Lebanon's deposit levels at significant risk.

Indeed, we see potential, albeit limited, for an improvement in the domestic environment following the formation of a unity government earlier this year. Prime Minister Tammam Salam formed a government in February 2014, after nearly one year of negotiations following his appointment. The government comprises centrists, as well as both the March 14 and March 8 political alliances, the former led by former Prime Minister Hariri, who opposes the Assad regime in Syria, and the latter 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.

We anticipate little in the way of reform or policymaking from the new Lebanese government. Even in stable times, policymaking in Lebanon is constrained by its divisive political environment, and institutional and governance effectiveness remains a main ratings weakness. Moreover, this government will be short-lived; by law, it must resign when a new president is elected by the parliament. Constitutionally, this is due by May 25. Even if a government is formed quickly thereafter, parliamentary elections are due in

November. On balance, however, we view the formation of the government as a sign that the main political parties and key actors remain committed to reducing the risks of a renewed escalation of domestic conflict in Lebanon.

We do not expect a meaningful economic recovery or a significant improvement in macroeconomic fundamentals, which have deteriorated over the last three years. The Syrian crisis will continue to weigh heavily on Lebanon's growth prospects, depressing its services-driven economy that is highly sensitive to swings in consumer and investment confidence. We do not anticipate a significant rebound in tourism, financial and trade services, or foreign direct investment in 2014, and therefore do not foresee a material improvement in Lebanon's macroeconomic fundamentals or creditworthiness, despite the stability of deposits and high central bank reserves. We estimate that real GDP per capita growth will average 0.8%, although we note that our population figures do not account for the large refugee population living in Lebanon.

The slowdown in economic growth is straining Lebanon's already-weak public finances, in a political environment that was not conducive to reforms even during periods of strong growth. The deficit widened in 2013 to 9.5% of GDP, and we expect it will remain at similar levels given pressure on revenues and little expenditure flexibility. 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. The primary balance has turned increasingly negative, highlighting the lack of fiscal space, which in turn is contributing to the rise in general government debt. We expect general government debt to rise to 147% of GDP in 2014. Under our base case, a parliamentary bill to increase public-sector wages will not be approved without offsetting revenue measures.

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 the refugees. The Syrian crisis has displaced millions of people, both internally and outside of the country. The UN High Commissioner for Refugees estimates that the Syrian refugee population in Lebanon could reach 1.5 million by the end of 2014, increasing the population of Lebanon by about one-third. In the medium term, the impact of the increasing number of Syrian refugees on Lebanese politics and society, as well as the economy, as pressure increases on public spending, services, infrastructure, and the labor market, will become a greater concern for the Lebanese government.

Outlook

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.

If the political and economic situation deteriorates to the point where it staunches deposit growth, 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

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Nominal GDP (US$ bil)	28.8	35.1	38.0	40.1	42.5	44.2	46.2	48.8	52.3	56.1
GDP per capita (US$)	6,888	8,274	8,756	8,950	9,148	9,330	9,563	9,898	10,395	10,943
Real GDP growth (%)	9.1	10.3	8.0	2.0	1.5	1.0	1.5	2.5	3.5	3.8
Real GDP per capita growth (%)	7.9	8.7	5.6	(1.1)	(2.2)	(1.0)	(0.5)	0.5	1.5	1.7
Change in general government debt/GDP (%)	17.4	11.6	3.8	2.6	9.5	13.1	9.5	9.5	9.0	8.5
General government balance/GDP (%)	(10.1)	(8.4)	(7.6)	(5.8)	(9.2)	(9.5)	(9.5)	(9.5)	(9.0)	(8.5)
General government debt/GDP (%)	163.2	145.6	138.4	133.9	135.7	143.5	146.8	148.5	147.6	146.0
Net general government debt/GDP (%)	144.1	125.7	118.5	115.7	115.5	120.3	124.5	127.5	128.0	127.7
General government interest expenditure/revenues (%)	47.0	45.5	46.5	40.2	38.5	40.2	43.7	42.2	41.6	41.2
Oth dc claims on resident non-govt. sector/GDP (%)	73.0	69.0	79.8	85.4	89.0	93.8	97.8	101.9	106.6	111.2
CPI growth (%)	5.5	3.4	4.6	4.0	6.0	4.0	4.0	4.0	4.0	4.0
Gross external financing needs/CARs +use. res (%)	118.3	110.5	101.4	91.9	92.9	92.9	104.9	98.6	101.2	104.5
Current account balance/GDP (%)	(14.4)	(20.0)	(19.9)	(12.1)	(10.6)	(12.3)	(13.4)	(14.8)	(16.2)	(16.0)
Current account balance/CARs (%)	(13.1)	(23.2)	(24.5)	(13.8)	(12.2)	(14.8)	(16.3)	(17.9)	(19.7)	(19.6)
Narrow net external debt/CARs (%)	(55.2)	(88.9)	(111.0)	(95.7)	(95.8)	(73.4)	(78.9)	(71.0)	(59.3)	(51.4)
Net external liabilities/CARs (%)	21.1	11.2	3.7	10.0	13.9	44.2	42.8	57.9	73.2	87.9

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.

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
- Understanding National Rating Scales, April 14, 2005

Related Research

- Sovereign Defaults And Rating Transition Data, 2012 Update, March 29, 2013

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 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.

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

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

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