Moody's Investors Service

Rating Action: **Moody's changes outlook on Lebanon's B2 ratings to positive**

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DIFC, December 18, 2009 -- Moody's Investors Service has today changed the outlook on Lebanon's B2 government bond issuer ratings to positive from stable. The rating action was prompted by a continuation of the positive trends that led Moody's to upgrade Lebanon's sovereign ratings in April: namely, the continued improvement in external liquidity, the strengthened ability of the country's resilient banking system to finance fiscal deficits, and an amelioration of the domestic political situation with the formation of a consensus government in November.

Moody's has also changed the outlook to positive from stable on Lebanon's B2 country ceiling for foreign currency bank deposits and B1 country ceiling for foreign currency bonds.

"Lebanon's public finances have proven resistant to serious political and economic shocks in recent years. This is due to the strengthened resilience of the country's banking system, which is the government's primary creditor," explains Tristan Cooper, Vice President/Senior Credit Officer and Moody's head analyst for Middle East sovereigns. "Confidence in Lebanon's financial system has been bolstered by the central bank's large and growing cushion of foreign exchange reserves and its effective regulation of domestic banks."

Moody's notes that the central bank's foreign exchange reserves rose to US$24.1 billion in October 2009, up from US$9.8 billion at the end of 2007. This places the country in a more favourable position to absorb financial shocks while also providing ample cover for the government's maturing foreign currency debt. Moreover, the central bank holds a large amount of gold, worth US$9.6 billion in October, although the liquidity of the gold could potentially be constrained given that parliament must approve its sale.

The maturity structure of government debt is also favourable; following a voluntary debt exchange in March 2009, the government does not face a significant Eurobond maturity until March 2010. In 2010 as a whole, the government's Eurobond maturities amount to around US$2 billion.

Lebanon's commercial banks remain liquid, are well-capitalised and have continued to attract deposits from abroad. Total bank deposits increased by around 20% in the 12 months to October. Moody's notes that Lebanon's banks were not exposed to toxic financial assets or failed western financial institutions during the global financial crisis, partly because of stringent central bank regulations. While there is a risk that bank deposits could fall in the event of a serious political or economic upheaval, Moody's observes that they have displayed a high level of stability during previous crises. The bulk of deposits are sourced from the country's large and loyal diaspora.

"Despite the recent improving trends, Moody's is well aware of Lebanon's significant political and economic vulnerabilities. These include wide twin deficits, a very high public debt overhang, a tense domestic political environment, and a precarious geopolitical location," says Mr. Cooper. The rating agency cautions that there is no guarantee that the government's weak policy effectiveness will improve despite the formation of a consensus government in November. Moody's remains concerned by the sluggish progress in implementing much-needed economic reforms.

"However, Moody's believes that such risks are adequately encapsulated in Lebanon's ratings," says Mr Cooper. Moody's also derives reassurance from Lebanon's history of financial support from committed external donors.

For the rating to move up to B1, Moody's said a continuation of the positive developments outlined above would be needed. Namely, a further strengthening of the government's ability to finance its wide fiscal deficit and a further improvement in the government's poor debt affordability metrics. A serious disruption to the political environment that halted these positive trends may jeopardise a ratings upgrade.

The last rating action on Lebanon was implemented on April 1, 2009, when Moody's upgraded the government's foreign and local currency debt issuer ratings and the country ceiling for foreign currency deposits to B2 from B3 and the country ceiling for foreign currency debt from B2 to B1.

The principal methodology used in rating the government of Lebanon is Moody's Sovereign Bond Methodology, published in September 2008, which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

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