Fitch Affirms Lebanon at 'B-'; Outlook Stable

Fitch Ratings-London-13 February 2007: Fitch Ratings has today affirmed the Republic of Lebanon's foreign and local currency Issuer Default ratings at 'B-' (B minus) with Stable Outlooks. The Short-term foreign currency rating is also affirmed at 'B' and the Country Ceiling at 'B-' (B minus).

"The Stable Outlook on what is a very low rating balances increasing political tensions and damage to public finances following last summer's war with Israel against the generous support once again demonstrated by donors. January's Paris III conference brought pledges of USD7.6bn in grants and concessional loans" says Richard Fox, Head of Middle East and Africa sovereign ratings at Fitch. "Although no end is in sight to the political stand-off between government and opposition, key early warning indicators of financial market stress, such as international reserves and bank deposit levels, have remained remarkably robust."

Support from official donors, expatriate Lebanese and Lebanon's large banking system remains the key to understanding Lebanon's ability to support one of the world's highest gross public debt ratios of 180% of GDP. Bank deposits of 235% of GDP are second only to those of Luxembourg and Hong Kong relative to economic size. Consequently, with limited investment opportunities, banks hold over half of all government debt, including foreign currency eurobonds, and yet this still amounts to a relatively low 75%-80% of broad money. This is lower than in many more highly rated sovereigns and significantly lower than its previous peak of almost 90% in 2002 on the eve of the Paris II donor conference. Gross foreign currency reserves of around USD11bn are also substantially higher than the USD3bn they sank to five years ago. Although these are to a large extent the counterpart of banks' foreign currency liquidity deposits, they nevertheless are a reminder that the country's banks are highly liquid, with almost 50% of their balance sheets in liquid foreign currency assets either at the central bank or abroad. A sustained fall in non-resident deposits or broader capital flight would quickly be reflected in a slump in banking system deposit growth. However, the latter seems unlikely in the aftermath of the major expression of confidence in the Lebanese government marked by the Paris III outcome.

With foreign currency reserves essentially supporting the integrity of the banking system and the peg to the USD, keeping the confidence of domestic investors in order to maintain their exposure to government debt is paramount. In this regard, the government is working with donors on the details of a reform programme to be monitored by the IMF. Conditionality is unlikely to be onerous in 2007 as Lebanon recovers from the war, allowing substantial disbursements from Paris III funds, up to USD2bn of which are grants. Disbursement from money pledged at last year's Stockholm conference and bilaterally is also available to ease the financing of the large budget deficit that rose to 14% of GDP last year as the economy contracted by an estimated 5% due to the war.

Bank deposit and loan dollarisation are very high, but in times of stress, deposits are switched into foreign currency rather than leaving the banking system altogether. This acts as a crucial buffer. The purchase of foreign currency eurobonds by Lebanese banks is also supportive of the government's foreign currency financial management. Previous debt management operations have reduced eurobond maturities to only USD1.2bn this year, USD750m of which is due at end-February.

In Fitch's view, recent political and economic turbulence and the current balance of risk scenarios is reflected in the 'B-' (B minus) rating. However, despite the resilience of the Lebanese financial system to date, the current political stalemate and rising tensions are taking their toll and if not resolved could eventually result in a higher degree of financial stress than is currently evident. By contrast, a political resolution would quickly translate into rising confidence.

A full credit analysis report will shortly be available to subscribers at www.fitchresearch.com

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