

Research Update:

Lebanon Outlook To Negative On Increased Risk Of Prolonged Domestic And Regional Instability; 'B/B' Ratings Affirmed

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Related Criteria And Research

Ratings List

Research Update:

Lebanon Outlook To Negative On Increased Risk Of Prolonged Domestic And Regional Instability; 'B/B' Ratings Affirmed

Overview

- In our view, heightened tensions in Lebanon stemming from ongoing unrest in Syria indicate increased and prolonged domestic and geopolitical risks for Lebanon.
- We believe the balance of risks to the rating have shifted to the downside, so we are revising our outlook on the long-term sovereign credit rating on Lebanon to negative from stable.
- The negative outlook reflects our view that the security situation in Lebanon may deteriorate in tandem with Syrian developments, threatening government stability in Lebanon--which could put deposit levels at risk and potentially strain already weak public finances and the central bank's ability to maintain its currency peg to the U.S. dollar.
- We are affirming our 'B/B' long- and short-term foreign and local currency sovereign credit ratings on Lebanon.

Rating Action

On May 28, 2012, Standard & Poor's Ratings Services revised the outlook on the long-term sovereign credit rating on the Republic of Lebanon to negative from stable. At the same time it affirmed its 'B/B' long- and short-term foreign and local currency sovereign credit ratings on Lebanon. The transfer and convertibility (T&C) assessment remains at 'BB-' and the recovery rating at '4'.

Rationale

The outlook revision reflects our view that the balance of risks to the ratings on Lebanon has shifted to the downside as the Syrian conflict shows no sign of abating. Heightened domestic tensions in Lebanon--as pro- and anti-Assad sectarian factions skirmish in the Tripoli region as well as in Beirut--indicate to us that Lebanon's domestic stability has become increasingly more vulnerable to events in Syria.

That said, our affirmation of the ratings reflects our view of Lebanon's political and macroeconomic resilience; it has withstood both domestic and geopolitical turmoil in recent years. Since the formation of the March 8 Alliance-led government under Prime Minister Najib Mikati in June 2011, the Lebanese government has maintained a greater degree of stability than a number of its neighbors in the Middle East and North Africa (MENA) region.

However, despite the government's efforts to avoid getting drawn into neighboring conflicts, we see an increasing possibility that the Syrian civil war could destabilize Lebanese society and politics.

At the 'B' rating level, we see Lebanon's banking system and external position as key rating strengths (see "BICRA On Lebanon Maintained At Group '8' Following Affirmation Of Sovereign Ratings, published Feb. 21, 2012, on the Global Credit Portal). Bank deposits grew 2.6% in the first quarter of 2012, driven largely by nonresident deposit inflows, providing both balance of payment support and sources for additional government financing. The Banque du Liban's (the central bank's) international reserves rose to \$31 billion at March 31, 2012. Combined with the external assets of the financial system, they are 1.5x external debt. Combined with projected 2012 current account receipts, they exceed Lebanon's projected 2012 gross external financing needs.

Deposits in Lebanon are traditionally sticky--a significant share of deposits comes from the Lebanese diaspora, who are well aware of the political risks in the country. However, previous instances of acute domestic and regional turmoil have led to brief periods of deposit outflows (albeit in low-single-digit percentages) including the collapse of the government in January 2011 (\$1.1 billion withdrawn), the 2006 conflict with Israel (\$3 billion), and the 2005 assassination of Prime Minister Rafic Hariri (\$2 billion).

Although Lebanon's external stock positions are favorable, balance of payment risks do remain. The financial sector moved into a small net external debtor position last year and Lebanon reported current account deficits (CADs) exceeding 20% of GDP in 2010 and 2011. Unallocated remittances and border trade may have funded some of these CADs, but much was funded by deposit inflows into Lebanon's banking sector and with debt.

The unrest in Syria meanwhile continues to hurt economic activity in Lebanon, depressing transit trade, tourism revenues, and foreign inflows. The fiscal deficit is likely to widen this year to 8% of GDP. As in previous years, a budget will not likely be passed this year. If it were, this would help implement necessary reforms to reduce subsidies, borrowing needs, and general government debt, which we estimate at over 130% of GDP at Dec. 31, 2011.

Outlook

The negative outlook on the long-term ratings reflects our concern that domestic tensions and the escalation of violence in Lebanon could destabilize domestic politics, exacerbate tension between the March 8th and March 14th Alliances and between pro- and anti-Assad sectarian groups, and potentially lead to a breakdown in the government. We believe that such an outcome could put further pressure on the economy and aggravate Lebanon's fiscal and external vulnerabilities.

We could lower the ratings if domestic or regional security deteriorates to an

extent that it adversely affects deposit inflows over an extended period, in turn straining the government's ability to raise and roll-over its debt and undermining the economy's ability to fund the large CAD and the central bank's ability to maintain the currency peg to the dollar.

We could revise the outlook to stable if there is an improvement in domestic stability, either due to an improvement in regional stability or improved government cohesion and policymaking.

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Criteria For Determining Transfer And Convertibility Assessments, May 19, 2009
- Introduction Of Sovereign Recovery Ratings, June 14, 2007
- BICRA On Lebanon Maintained At Group '8' Following Affirmation Of Sovereign Ratings, Feb. 21, 2012

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Lebanon (Republic of) Sovereign Credit Rating	B/Negative/B	B/Stable/B

Ratings Affirmed

Lebanon (Republic of) Transfer & Convertibility Assessment	BB-
Recovery Rating	4
Senior Unsecured	B
Short-Term Debt	B

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Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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