Fitch Downgrades Lebanon to 'CCC'

Fitch Ratings, London, 23 August 2019: Fitch Ratings has downgraded Lebanon's Long-Term Foreign-Currency Issuer Default Rating (IDR) to 'CCC' from 'B-'.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

The downgrade of Lebanon's IDRs reflects intensifying pressure on Lebanon's financing model, increasing risks to the government's debt servicing capacity. Downward pressure on banking sector deposits and central bank foreign reserves and increasing dependence on unorthodox measures by the central bank (Banque du Liban, BdL) to attract inflows illustrate increased stress on financing. The government is relying largely on financing from the central bank, both in domestic debt markets and for repayment of Eurobonds. While recent policy steps point to nascent fiscal adjustment, a credible medium term plan to stabilise government debt/GDP is lacking.

Lebanon requires substantial capital inflows to fund its large twin budget and current account deficits. We estimate gross external financing needs at 24% of GDP in 2019. However, total deposits in commercial banks (excluding public sector deposits) have declined since end-2018. FX deposits were 3.6% higher yoy in June, because of conversion of LBP deposits to US dollar deposits rather than fresh inflows. Dollarisation reached 71.5% in June, up from 68% a year earlier. Non-resident FX deposit growth was less than 3% yoy (picking up to 4.6% in July, according to BdL, linked to the central bank's latest financial operation launched in June). The average interest rate on FX deposits, at 5.8% in June, suggests that net of accumulated interest earnings, the stock of FX deposits would have also fallen.

Deposit inflows have traditionally been attracted by confidence in the currency peg against the US dollar, free movement of capital and attractive spreads on US dollar-deposits over US interest rates and on Lebanese pound-deposits over local US dollar-deposits. Weakening confidence stems from domestic political instability and government ineffectiveness, deteriorating economic growth and geopolitical risks, including US policy against Iran (and Hizbollah) and weaker relations between Lebanon and Gulf countries. In January, the minister of finance raised the possibility of restructuring domestic debt to reduce the interest burden for the government. These remarks were retracted, but aggravated depositor concerns. Slow budget approval and recent cabinet deadlock in July have provided no relief.

External financing pressure has increased. The net FX position of the financial sector (used as a proxy for the balance of payments) showed a deficit of USD5.4 billion in 1H2019, according to BdL figures. At end-June, BdL's gross FX reserves totalled USD29.8 billion, down by USD2.8 billion since end-2018 and 10% lower yoy. BdL also holds USD3.8 billion of other FX assets (excluding Lebanese Eurobonds) and USD13 billion in gold (which it needs parliamentary approval to touch).

FX reserves increased by USD0.7 billion in July, according to BdL, helped by the latest financial operation, which we expect will provide only temporary relief to external financing pressures. This operation, which involves BdL incentivising bank to offer roughly 14% returns on three-year blocked USD deposits and then place these US dollars in turn at BdL, is ongoing and, according to BdL attracted USD1.5 billion by end-July and USD2.3 billion to date. There is not a one-to-one relationship between attracted inflows and reserve numbers.

Given large external financing needs, with the current account deficit at 20% of GDP, we forecast BdL's gross FX reserves (excluding gold and other foreign currency assets) to decline to around USD29 billion by end-2019 and another USD3 billion each year in 2020 and 2021 (close to 5.5% of GDP roughly). We expect BdL could sell more of the USD3.8 billion of its other foreign securities (excluding USD2.9 billion of Lebanese Eurobonds). FX reserves/M2 would fall below 60% in 2019 and to 48% in 2021, which would be the lowest since 2000-2002, when the ratio reached 37%, at a time of conflict with Israel and economic downturn in developed markets. Deposit inflows recovered strongly in 2003-2004.

The central bank's foreign currency position is significantly weaker when viewed in net rather than gross terms, because it has large FX liabilities to Lebanese commercial banks, which we estimate at USD62 billion in June, of which USD19 billion are mandatory reserve requirements. A mitigating consideration is that the BdL's foreign assets (excluding gold) are largely liquid, while the FX liabilities to banks have much longer average maturity. Nonetheless, in Fitch's view the weaker net position is relevant in a situation where banks require access to their USD dollar deposits at BdL, for example if weak depositor confidence prompts more withdrawals. Banks face a large maturity mismatch between their FX assets and liabilities, even though they have managed to extend the average maturity of customer deposits.

The central bank pays out higher interest rates to attract USD deposits then it earns on its FX reserves. In addition, recent financial engineering operations have placed an increasing financial burden on BdL's LBP operations. The "other assets" line of the BdL balance sheet, which may partly represent an accounting balancing item in Fitch's view, has doubled since January 2016 to around 30% of GDP.

Recent policy steps indicate nascent fiscal adjustment, but a medium term strategy to stabilise government debt/GDP is lacking. The government has started to implement the Electricity Reform Plan (ERP) agreed in April. The 2019 budget, ratified by the president in August, targets a deficit of 7.6% of GDP, from 11.1% in 2018. There seems to be commitment to approving the 2020 budget more promptly. Nonetheless, the factional nature of domestic politics renders the country vulnerable to periods of political vacuum and policy inertia.

We forecast a deficit of 9.2% of GDP in 2019. Revenue projections seem optimistic given weak economic growth and inefficient tax collection. We project nominal GDP growth of 3.3%, compared with the government assumption of 5.7%. The overall spending allocation may prove realistic, provided that the government can maintain discipline on no new hiring, and that the stock of arrears is not higher than estimated. In January-June the deficit was around 4.2% of our forecast annual nominal GDP.

Even if the budget plan were fully realised, it would only be a first step towards stabilizing government debt/GDP (152% at end-2018). Given the weak growth outlook, we estimate that the government would need to run a primary surplus of at least 5% of GDP over the next four years to stabilise government debt/GDP. This indicates the extent of fiscal and structural reform required to put government debt on a sustainable footing, unless Lebanon can access a period of cheap financing or experiences a positive shock to growth.

The ERP aims to eliminate the deficit of Electricte du Liban (EDL), the state electricity company, in 2022-2023. EDL has run persistent annual deficits, averaging 3% of GDP over the last 15 years. It seems there is greater political will to tackle the problem now, given its central positon in political discourse and as part of the CEDRE conference of April 2018 at which USD11 billion of concessional loans were pledged for infrastructure projects over the medium term. Nonetheless, there is significant risk of delays and room for political disagreement over procurement decisions. We assume the EDL deficit will decline from 3% of GDP in 2018 to 1.9% in 2021.

Lebanon's 'CCC' IDRs also reflect the following key rating drivers:

Lebanon's unblemished track record of public debt repayment and the depth of the financial system (deposits in commercial banks are around 300% of GDP), remain rating strengths. Public debt is predominantly held by the country's large banking sector and monetary authority and non-resident depositors are mostly diaspora Lebanese. This close-knit nature of the financial sector has helped the government manage its large burden of debt over an extended period of time. Lebanon has had very few episodes of deposit outflows in the last 15 years.

Growth prospects remain modest without improvements in the external environment, a stronger reform programme or a boost to investment through the implementation of CEDRE projects. Growth averaged 1.4% in 2011-18, since the outbreak of the Syrian war, an extremely weak performance relative to the historical trend.

GDP per capita and broader human development indicators are well above current median for the 'B' category, although governance indicators are weaker. Geopolitical risks are material, including related to enmity between Hizbollah and Israel, US policy against Iran and the rivalry between Saudi Arabia and Iran.

Fitch typically does not assign Outlooks or apply +/- modifiers for sovereigns with a rating of 'CCC' or below.

ESG CONSIDERATIONS

Lebanon has an ESG Relevance Score of 4 for human rights and political freedoms as scores for the Voice and Accountability pillar of the World Bank Governance Indicators are relevant to the rating and a rating driver.

Lebanon has an ESG Relevance Score of 5 for Political Stability and Rights as World Bank Governance Indicators have the highest weight in Fitch's Sovereign Rating Model and is therefore highly relevant to the rating and a key rating driver with a high weight.

Lebanon has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as World Bank Governance Indicators (for which Lebanon scores well below peers) have the highest weight in Fitch's Sovereign Rating Model and is therefore highly relevant to the rating and a key rating driver with a high weight.

Lebanon has an ESG Relevance Score of 3 for International Relations and Trade as complex geopolitical relationships are relevant to the rating and a rating driver.

Lebanon has an ESG Relevance Score of 4 for Creditors' Rights as willingness to service and repay debt is relevant to the rating and a rating driver, as it is for all sovereigns.

SOVEREIGN RATING MODEL (SRM) and QUALITATIVE OVERLAY (QO)
In accordance with its rating criteria, for ratings in the 'CCC' range and below, Fitch's sovereign rating committee has not utilized the SRM and QO to explain the ratings, which are instead guided by the ratings definitions.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LT FC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

RATING SENSITIVITIES
The main factors that could, individually or collectively, lead to positive rating action are:
-Improved outlook for external financing, such as non-resident deposit inflows into the banking system or other substantial inflows of external support.
-An improvement in public debt dynamics, whether through fiscal tightening or stronger economic growth.

The main factors that could, individually or collectively, lead to negative rating action are:
-Critical weakening of the government's capacity to secure financing to meet debt servicing needs
-Inability of BdL to maintain sufficient gross FX reserves to retain confidence in the currency peg.
-Indications that the government is planning for debt restructuring.

KEY ASSUMPTIONS
Fitch assumes that international oil prices will average USD65/b in 2019, USD62.5/b in 2020 and USD60/b in 2021.

The full list of rating actions is as follows:

Long-Term Foreign-Currency IDR downgraded to 'CCC' from 'B-'
Long-Term Local-Currency IDR downgraded to 'CCC' from 'B-'
Short-Term Foreign-Currency IDR downgraded to 'C' from 'B'
Short-Term Local-Currency IDR downgraded to 'C' from 'B'
Country Ceiling affirmed at 'B-'
Issue ratings on long-term senior unsecured foreign-currency bonds downgraded to 'CCC' from 'B-'

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