

Lebanon Macro View

The gap widens between country and sovereign risk

- Country risk in Lebanon has risen dramatically in the past couple of years. The economy is struggling to maintain growth of around 2%, hit hard by regional and domestic unrest, most notably as a result of the conflict in Syria. The political scene has become increasingly fractured and domestic security has deteriorated as violence has risen across the country.
- That said, the risk of government default remains, in our view, relatively stable, leading to a growing divergence between country risk and sovereign risk. The sovereign's stable credit risk profile is down to two factors.
- Firstly, public finances, although weak, are no weaker than they were prior to the breakout of regional unrest, and are relatively steady. The government deficit has widened in recent months, but remains in line with historical averages. Moreover, the government debt burden has been steadily diminishing in recent years.
- Secondly, and perhaps more importantly, the Lebanese banking system remains both willing and able to support government debt. Domestic banks, which are around four times larger than Lebanon's total economic output, are the keystone to Lebanon's debt sustainability. Their willingness to continue financing the government rests on the fact that their own balance sheets would be severely damaged by a sovereign default. Their ability to do so has been bolstered by continued deposit inflows and rising cash reserves. So long as the banking system remains resilient to the political turmoil, we believe Lebanon's sovereign debt outlook will remain stable.
- Looking ahead, the resilience of the banking system to previous shocks makes it hard to envisage what kind of event may undermine depositor confidence and therefore sovereign debt sustainability. It would be unwise, in our view, to be complacent regarding the risks – it is entirely possible that there could be a tipping point where things get bad enough politically and/or economically that depositors begin to pull out. Where that point lies is hard to judge, but past experience suggests that we have a way to go before we reach it.

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With thanks to

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The gap widens between country and sovereign risk

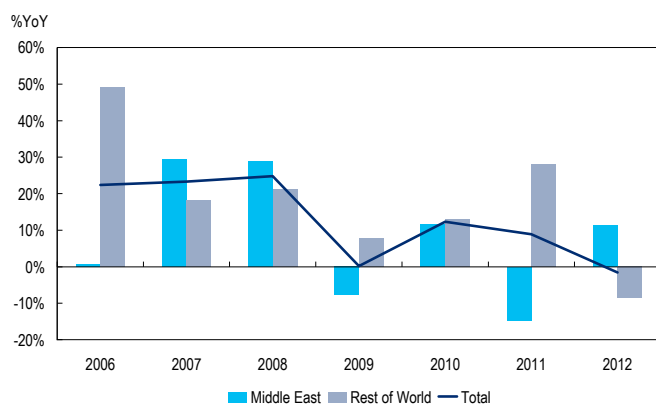
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Country risk refers to the risks of doing business in a country: economic risks, as well as security, political and regulatory risks, even risks from the natural environment. Sovereign risk, on the other hand, has a much narrower definition, and is concerned solely with the risk that a Sovereign will meet its financial obligations as and when they fall due in full and on time. Country risk and sovereign risk are often highly correlated, but there are instances where the two diverge significantly. This is the case currently in Lebanon, where a sharp deterioration in country risk over the past couple of years has had, in our view, little impact on sovereign risk so far.

An unwelcome spring

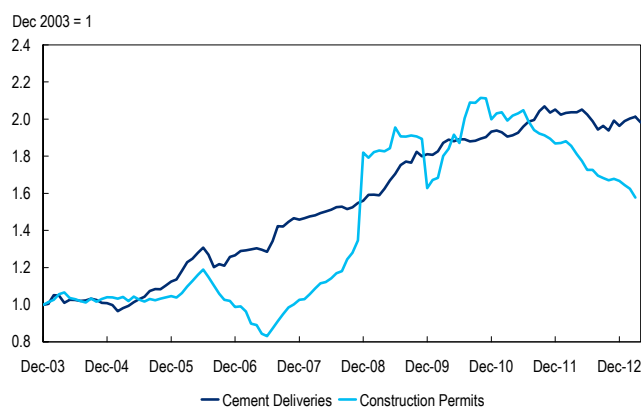
Lebanon has suffered as a result of the political instability that has plagued the region since early 2011. The Lebanese economy rode out the global financial crisis and global economic downturn remarkably well, with real economic growth remaining over 8% per year between 2007 and 2010. However, local and regional conditions turned markedly for the worse in 2011. The 'Arab Spring' led to major economic turbulence in some of Lebanon's key export markets, hitting trade (Figure 1). This was exacerbated by the descent of Syria into civil war, which has led to the closure of key overland trade routes to Iraq and beyond. Domestically, the fall of the Hariri government in January 2011 highlighted the dysfunction of Lebanon's confessional politics, while Syria's civil war has heightened sectarian tensions between local pro-Assad and anti-Assad groupings. Security has suffered, with violence breaking out in various parts of the country (but mostly in the northern city of Tripoli and in the Bekaa Valley). Most recently, these factors have contributed to the resignation of the Najib Mikati government (which replaced that of Hariri and was backed by a March 8 Hizbollah-aligned coalition). It has been over three months since Prime Minister Designate Tammam Salam first began attempts to form a new government, to no avail.

Figure 1. Arab Spring has had a negative impact on trade



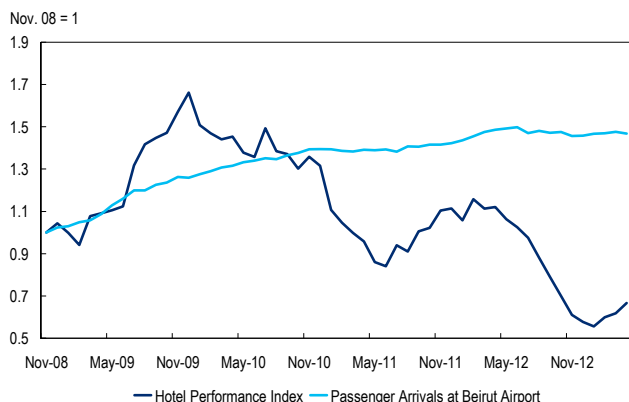
Source: Haver Analytics, Citi Research

Figure 2. Construction lead the way to a real estate slump



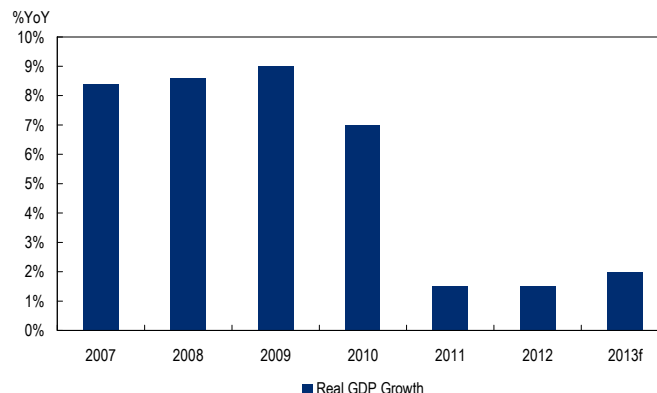
Source: Haver Analytics, Citi Research

Figure 3. Tourism is significantly depressed



Source: Ernst & Young, Haver Analytics, Citi Research

Figure 4. Overall economic growth has suffered



Source: Haver Analytics, Citi Research

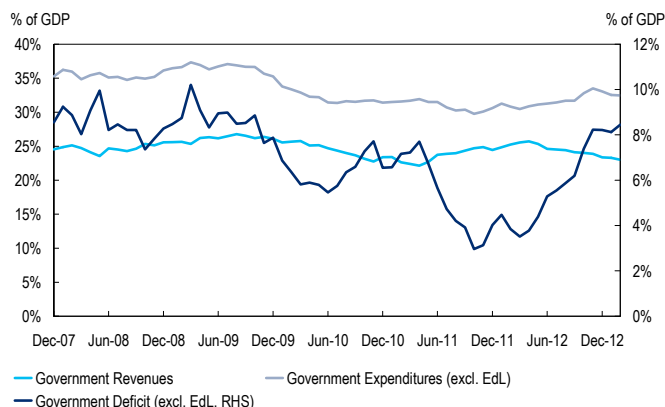
The impact of these events on investor and business confidence has been profound. A great deal of foreign investment and external demand (for example in the real estate and tourism sectors) has traditionally come from the Gulf Arab countries, whose relations with the Hizbollah-backed ruling coalition have been strained, and whose citizens have recently been targeted by local extremists. As a result, real estate, one of the key pillars of the Lebanese economy, has experienced a severe downturn, with a direct knock-on effect to the construction industry (Figure 2). Tourism, another key earner for Lebanon, has likewise suffered. The Gulf Arab countries have in recent months put travel warnings out to citizens considering going to Lebanon, and have begun to repatriate students studying in Lebanese universities. Hotel occupancy is down significantly over the past two years, as are average room rates, leading to a massive fall in revenue across the industry (Figure 3).

Taken together, the negative environment for trade, construction and tourism, against a backdrop of ongoing political instability and depressed investor confidence, the impact on overall GDP has been, unsurprisingly, negative. Growth in the past two years has averaged just 1.5%, and we are expecting only a modest rise in 2013, well below the pre-2011 trend. Indeed, the outlook does not look promising, with Lebanon seemingly becoming increasingly drawn into the civil war next door in Syria, and the risk of spillover rising. A recent attack on Army troops by armed loyalists of a radical Sunni cleric in the town of Abra, near Sidon, represents a worrying escalation in local violence. The attack led to the death of at least 15 Lebanese soldiers in ensuing clashes, which were still raging at the time of writing.

The sovereign, though, remains well supported

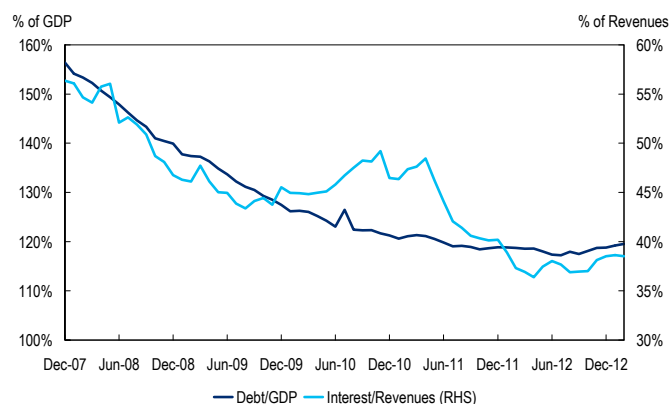
There is little doubt that Lebanon's country risk profile has increased dramatically in recent months. However, the extent to which this is true of the country's sovereign risk is less clear. While the political instability and deteriorating security are weighing heavily on the real economy, government finances and, crucially, the banking sector's ability to support them, appear to be fairly resilient.

Figure 5. Public finances have been relatively stable



Source: Haver Analytics, Citi Research

Figure 6. The debt burden has come down



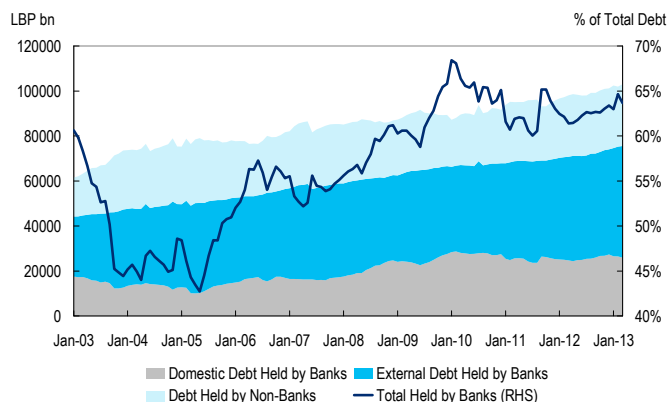
Source: Haver Analytics, Citi Research

Lebanon's budget deficit at the end of 2010 (excluding expenditures on the state electricity company EdL) stood at around 6% of GDP. A year into the regional unrest at the end of 2011, the deficit had narrowed to 4% of GDP. At end 2012, the deficit widened markedly, to 8% of GDP. There are a few points to make regarding this pattern. First, the 2012 deficit is not remarkable compared with pre-2011 fiscal outturns: Lebanon's public finances have always been relatively weak, and deficits around the 10% mark of GDP have been the norm in the past decade. Second, the narrowing of the deficit during 2011 reflects the inclusion of telecom receipts in government revenues (previously not included) which boosted revenue performance. Finally, the deterioration in the balance in the past year reflects a combination of the revenue effect of 2011 running its course, as well as a rise in expenditure owing to a retroactive public salary scale increase agreed by the Mikati government.

This is not to say that Lebanon enjoys robust public finances: certainly the budget suffers from structural weakness in revenues and sustained expenditure pressures. However, the point we make here is that the volatility in the deficit is not out of normal parameters and does not reflect a trend deterioration in government revenue capacity or in government expenditures (the salary rise was a one-off). Also, it is not related to the regional unrest. In other words, we consider that Lebanon's public finances have so far been much less affected than the wider economy by the events of the past two years. Indeed, the country's debt burden has actually eased during this time, with the Debt to GDP ratio falling to below 120% (from close to 160% six years ago), and debt service eating up less than 40% of revenues (compared with one half at the end of 2010).

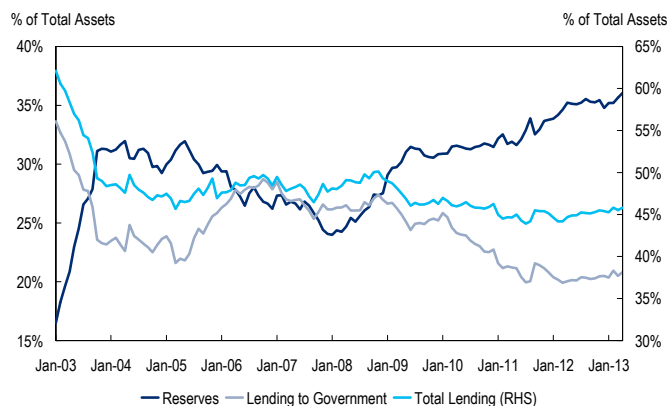
Perhaps more importantly, the ability of the government to finance its deficit via the domestic banking system has not only remained intact over the past two years but has actually strengthened. Lebanon's extensive public debt is sustained by financing from an out-sized banking system that currently holds assets amounting to almost four times the entire GDP of the country. Without support from the domestic banks, we believe Lebanon's debt would quickly become unsustainable. The ability and willingness of the banking sector to continue providing support to the sovereign is thus the key strength of Lebanon's otherwise weak sovereign risk profile.

Figure 7. Domestic banks remain a key support to government debt



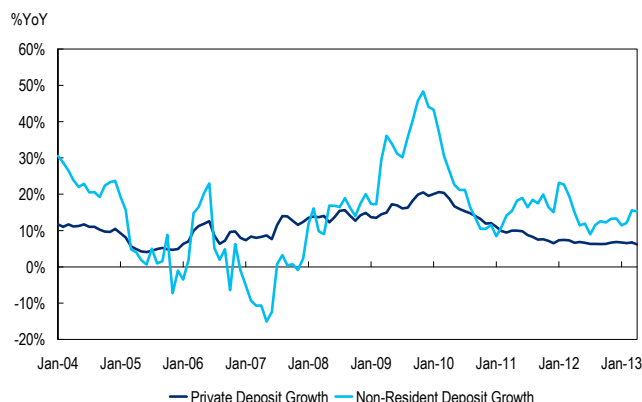
Source: Haver Analytics, Citi Research

Figure 9. Bank capacity to support government has increased



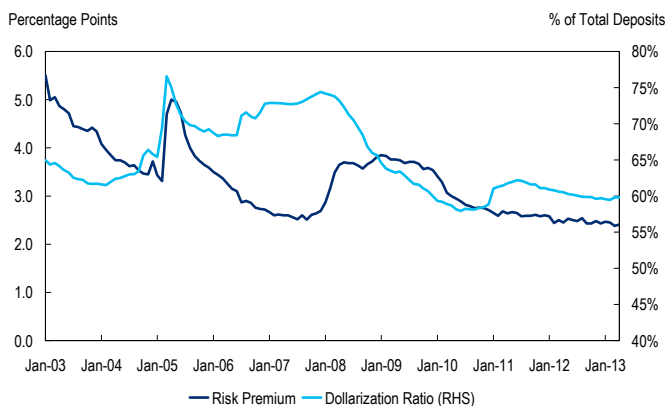
Source: haver Analytics, Citi Research

Figure 8. Deposit growth remains robust



Source: Haver Analytics, Citi Research

Figure 10. Risk indicators in banking sector are stable, despite politics



Source: Haver Analytics, Citi Research

The willingness of the banking system to continue providing support is, in our view, underpinned by the extent to which the banking system holds government debt. Directly, claims on the government amount to about half of total lending, and 20% of total assets. As the withdrawal of support would be likely to imply a sovereign default, in our view, the resulting write-down of these claims would severely impact capitalisation and viability of the domestic banking system. In other words, the banks probably cannot afford to let the sovereign go, and thus have a strong incentive to continue financing.

As for ability, the domestic banking system has once again proven itself remarkably resilient to political turmoil. Lebanese banks have gone through some periods of major instability in the past decade, from the assassination of former PM Rafik Hariri in 2005, to the war with Israel in 2006, to the heightened tensions and political assassinations of 2007/2008. Not only was there no sustained flight out of the banking system, but deposits and assets have grown in double digits annually throughout. Today, domestic private sector deposit growth stands at around 6%YoY, while non-resident deposit growth stands at 15% (Figure 8). These figures may be down from their peaks in mid 2009, but they remain robust and supportive of bank capacity to lend to the government.

Indeed, deposits have been growing at such a pace that the Lebanese banking sector is more liquid and has more free lending capacity than at any other time in the past decade. Total lending represents just 45% of total assets, while lending to the government has come down to just 20% of assets, from around 30% in 2006. Banks have been parking their excess liquidity with the Banque du Liban, and total reserves have risen steadily to over 35% of total assets (Figure 9).

The stability of the banking system is critical to Lebanese sovereign debt sustainability, and a loss of confidence on the part of depositors could quickly lead to capital flight and a dramatic reduction in the ability of the banks to support the sovereign. Depositor confidence rests on the belief that the banking system can survive the turmoil (assets will remain largely unaffected) and that the Lira peg to the dollar is secure (allowing continued funding in local currency). As mentioned, the banking system has remained remarkably stable in recent years, despite some major episodes of unrest. Importantly, confidence in the peg has also remained strong, with the premium demanded on lira deposits narrowing in recent years, and the dollarisation ratio falling (Figure 10). Both of these are key indicators of depositor confidence in the banking system, and suggest that local banks will be able to continue funding the sovereign for the foreseeable future.

Looking ahead, the resilience of the banking system to previous shocks makes it hard to envisage what kind of event may undermine depositor confidence and therefore sovereign debt sustainability. It would be unwise, in our view, to be complacent regarding the risks – it is entirely possible that there could be a tipping point where things get bad enough politically and/or economically that depositors begin to pull out. Where that point lies is hard to judge, but past experience suggests that we have a way to go before we reach it.

Appendix A-1

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