



The contraction of the private sector activity in the second half of 2013 led to pessimistic expectations of several economists and business people. The purchasing managers' index for Lebanon (BLOM PMI) indicated deterioration in business conditions in the second half of last year whereby the PMI remained below 50 for 6 months in a row in 2013 in addition to the first month of 2014. Tourism, construction, and retail were the most hit sectors in the economy. Some analysts went to saying that the economy cannot withstand another year of unstable political and security situation and may end up in an economic crisis.

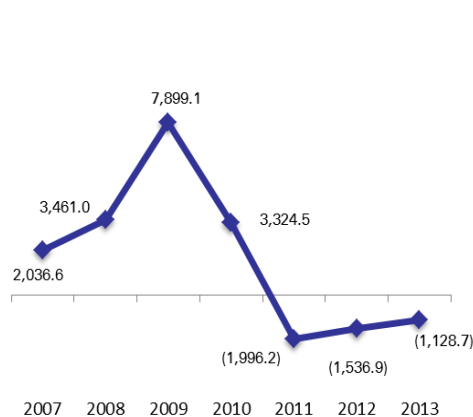
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Contact Information

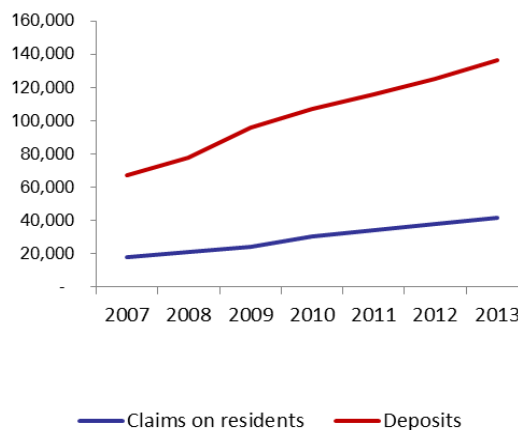
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**Balance of Payments (In \$M)
Deposits (In \$M)**



**Claims on Residents and Total
Deposits**



Source: Banque du Liban

The contraction of the private sector activity in the second half of 2013 led to pessimistic expectations of several economists and business people. The purchasing managers' index for Lebanon (BLOM PMI) indicated deterioration in business conditions in the second half of last year whereby the PMI remained below 50 for 6 months in a row in 2013 in addition to the first month of 2014. Tourism, construction, and retail were the most hit sectors in the economy. Some analysts went to saying that the economy cannot withstand another year of unstable political and security situation and may end up in an economic crisis.

However a detailed analysis of the main economic figures shows that 2014 may be a difficult year for both public and private sectors but it will remain a manageable one. Of course the ongoing civil war in Syria and its spillovers into Lebanon are adding up to the domestic political deadlock to depress both consumers' and investors' sentiments. In this context, any positive development on the domestic front will help improving the confidence and boosting economic activity. Moreover 2013 was to a certain extent a year of adaptation to a lower level of activity by businesses and therefore 2014 seems to be more difficult for the public sector than it is for the private sector. The latter is starting 2014 from a low base, as many sectors seem to have hit the bottom while the former has to deal with an expanding level of budget deficit and a higher debt to GDP ratio.

The evolution of the external sector shows the capacity of the Lebanese economy to continue financing both the public and the private sectors. Between 2007 and 2010, the balance of payments (BOP) realized a cumulative surplus of USD16.7 billion which is way above the absorption capacity of the economy. In the following three years, the BOP realized a deficit of USD4.7 billion, hence leaving the external sector with a

net cumulative surplus of USD12 billion over the period 2007-2013. Therefore the economy still has enough reserves to finance the economy as witnessed by the low market interest rates and the high liquidity ratios in the banking sector.

It also seems that capital inflows did not decline during last year despite the negative BOP and the estimated drop in foreign direct investments (FDIs) and tourism. The BOP recorded a deficit of USD1.1 billion in 2013 while the trade deficit increased by USD600 million and tourists number tumbled by 7%. Therefore the deterioration in the current account balance in 2013 was mainly behind the negative BOP, while capital inflows are estimated to have stabilized.

The banking sector was able during the last three years of negative BOP to finance both public and private sectors due to its accumulation of large liquidity during the previous period. The high interest rate differential between Lebanon and the US during the global financial crisis and the stability of the domestic banking sector were the two main factors behind the large foreign capital inflows to banks during 2007-2010. Hence, banks accumulated large liquidity as they were not able to place all these deposits into the Lebanese economy which boosted the negative carry-over of banks (the negative carry-over of banks is the difference between the higher interests that banks are paying on their liquidity compared to the interests they are receiving on this liquidity, which is an extra cost for the banks). This high liquidity is needed during periods of political and security instability when the economy is not able to attract large amounts of FDIs and high number of tourists, as it is the case in the past three years.

Both total deposits and claims on the resident private sector more than doubled in the past seven years. The former moved from USD67.3 billion in 2007 to USD136.2 billion at end 2013. When relating them to the economy, deposits amount to 3.2 times the GDP. As for loans to the private sector, they increased from USD17.7 billion in 2007 to USD41.5 billion by the end of last year or more than 95% of GDP.

During the 2007-2010 period, the central bank was accumulating large foreign reserves to provide more confidence to investors in its capacity to defend the peg. In fact, despite the war in Syria and its spillovers into Lebanon reflected by the domestic political and security instability, the peg was preserved. Not only that but there were not even real pressures on the Lebanese currency during the last three years as the central bank sits on ample gross foreign reserves of more than USD35 billion covering 19 months of imports

Regarding the public sector, the risk lies in the increasing fiscal deficit and debt to GDP ratio. 2013 is the first year where the government had a primary deficit in its budget. Debt to GDP ratio also reversed trend since 2012 following five years of decline. This was the result of a combination of factors. First, as economic growth dropped, automatic stabilizers started to work in addition to the increase in minimum wages that boosted expenditures. Second the lower inflation and lower GDP growth rates led to an increase in nominal GDP that is lower than the increase in public debt. Therefore debt to GDP ratio jumped from 135% in 2011 to more than 142% in 2013.

In a nutshell, 2014 appears to be a difficult however manageable year with a real economic growth rate expected between 1% and 2% depending on political and security developments. The growth rate may go higher than 2% if domestic political deadlines go smoothly and the security situation improves drastically.

The private sector will continue to face the challenges of 2013 but any improvement on the security front will give a big boost to this sector and especially to the tourism and retail components.

As for the public sector, investors are worried that reigning in the fiscal deficit and public debt does not seem at the forefront of government interests. Political and security issues are overshadowing economic problems. This could result in the reluctance by the private sector to continue lending to government despite having the capacity and the necessary liquidity to finance the sector. In this context, the formation of a new government that puts forward fiscal issues, mainly trying to go back to primary surplus and to put debt to GDP ratio on a downward trend, will surely have a positive impact on investors' sentiment.

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