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Research Department

Market Analysis**The Operating Environment in Lebanon and the MENA Region**

Throughout the course of 2018, the macroeconomic picture improved for both oil-importers and oil-exporters. Egypt witnessed a sizeable rebound in GDP growth while Saudi Arabia and Qatar have benefitted from fiscally prudent measures and higher oil prices. Jordan's tax hikes were met with popular outcry but the IMF-recommended measure is expected to gradually bring down the high debt-to-GDP ratio from around 96% of GDP to 77% of GDP in 2021.

As for Lebanon, it is eagerly waiting to unlock the \$11 billion of loans and grants pledged by the international community during the CEDRE conference and to kick-start much needed reforms.

Selected Economic Indicators – BLOMINVEST and IMF Estimates

	2016	2017	2018	2019	2020	2021	2022	2023	Estimates Start After
Gross domestic product, constant prices, % change	1.741	1.5	1	1.4	2	2.4	2.85	2.85	2016
Gross domestic product, current prices, \$ Billion	51.484	54.184	56.709	59.732	62.447	65.519	68.964	72.621	2016
Inflation, average consumer prices, % change	-0.816	4.476	6.516	3.528	2.427	2.427	2.427	2.427	2017
General government gross debt, % of GDP	145.454	146.794	149.992	152.922	157.428	161.962	166.708	172.371	2016

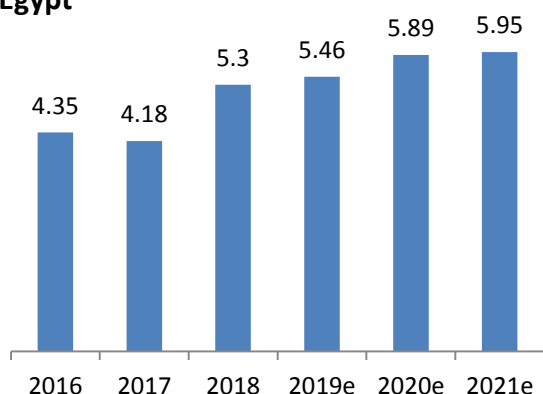
Source: BLOMINVEST Research Department, IMF Regional Outlook, October 2018

Lebanon's real Gross Domestic Product (GDP) growth rate has been revised downwards by the IMF to 1% in 2018, a result also in line with the implied GDP growth from the BLOM Lebanon Purchasing Managers' Index which averaged 46.3 in 2018. Inflation was fueled by higher housing and energy costs. According to the Central Administration of Statistics (CAS), the average yearly inflation rate rose from 4.44% in 2017 to 6.07% in 2018.

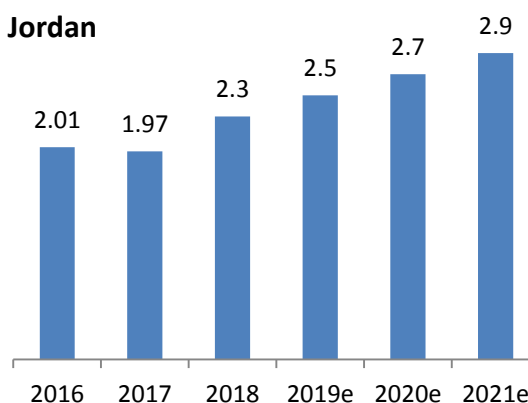
Outlook on the MENA Region

Real GDP Growth in %

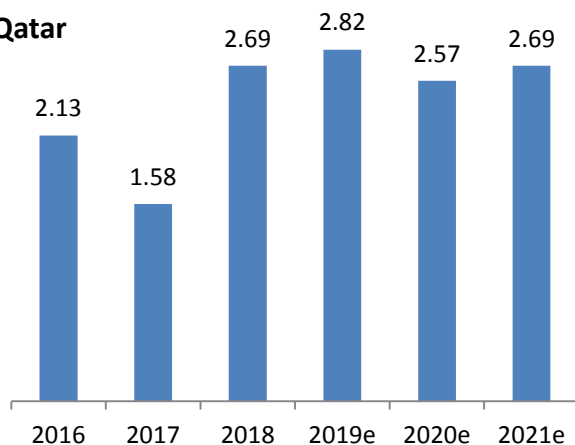
Egypt



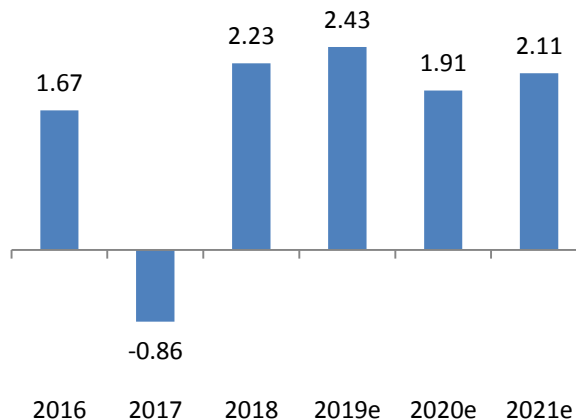
Jordan



Qatar



KSA



Source: IMF, World Economic Outlook

Over the past 15 years, Middle East, North Africa (MENA) oil exporters benefited from large external, fiscal surpluses and rapid economic expansion on the back of booming oil prices. Banks had ample liquidity from deposits sourced in public sector surpluses, which supported private sector credit and activity. However, as oil prices have plunged by some 60% since the middle of 2014, fiscal and external surpluses have turned into deficits and growth has slowed, raising concerns over the economic slowdown in the region and the heightened risks in the financial sector. According to the IMF, real GDP growth in the MENA region remained sluggish at 1.78% in 2017 and 2% in 2018.

Oil prices experienced important fluctuations during 2018. The average price of crude oil was \$71.69 per barrel up by 28.34% compared to the same period in the previous year. In fact, by the end of September, the crude oil price hit its highest levels since November 2014 to reach \$80 per barrel mainly due to supply losses from Venezuela and U.S. sanctions on Iran's energy industry, which came into force in November and were designed to cut crude exports from the third-biggest producer in the Organization of the Petroleum Exporting Countries (OPEC). However, starting October, oil prices began to decrease amid escalating concerns about an increase in global supply and a slowdown in economic growth to settle at \$53.8 per barrel by the end of 2018 comparing to \$66.87 per barrel by the end of 2017. The International Monetary Fund (IMF) forecasts oil prices at just below \$60 per barrel in 2019 and 2020 according to the World Economic Outlook report released in January 2019.

Oil Prices



Source: Bloomberg

The Saudi Arabian economy is recovering from a mild contraction in 2017, driven largely by higher oil production and rising consumer spending. Saudi crude oil production reached 10.4 million barrels per day in June 2018, its highest level since December 2016, just before the OPEC agreement for limiting production. The authorities are implementing tax reforms to reduce the fiscal dependence on oil-based sources. In January 2018, Saudi Arabia began collecting a 5 percent Value Added Tax (VAT). Combined, these new tax measures are expected to support increasing non-oil revenues. Moreover, the adoption of Vision 2030 has spurred reforms in several areas. Efforts have been made to improve the business environment and promote SMEs and financial sector reforms.

As for Egypt, macroeconomic conditions are improving since Egypt's twin deficits are narrowing and inflation has receded sharply in recent months. The Central Bank has cut key policy rates for the first time since the tightening cycle that accompanied the exchange rate flotation in November 2016. Economic activity is picking up, and unemployment rate has fallen below 12% for the first time since 2011. On the sectoral side, the extraction of gas has been a main contributor to growth. Moreover, the tourism sector is rebounding gradually, helped by the effect of local currency depreciation. Therefore, growth is projected to rise to 5.46 percent in 2019 compared to 5.3% in 2018.

Qatar is still recovering the losses incurred following the economic and diplomatic embargo imposed by its neighbors including United Arab Emirates and Saudi Arabia. Since the eruption of the crisis in June 2017, economic activity has rebounded in 2018 supported by a successful rerouting of trade flows, higher energy prices and 2022 FIFA World Cup related spending. Moreover, reforms protecting foreign workers and introducing permanent residency rights for expats will help with longer-term diversification effort. Hence, growth is expected to reach 2.82% in 2019, compared to 2.69% and 1.58% in 2018 and 2017, respectively.

In Jordan, growth will increase slightly from 2.5% in 2018 to 2.7 % in 2019. Growth is expected to be held back by ongoing delays in implementing structural reforms, a challenging regional environment and limited scope for public investment given the constrained fiscal position.

In addition to oil price fluctuations, MENA countries will face the spreading and deepening conflicts across the region. Among the oil exporters, Libya, Iraq, and Yemen are the most severely affected, with tragic humanitarian effects and massive damage to their economies. These conflicts (including in other MENA countries such as Syria) also have significant implications for neighboring countries, particularly Lebanon and Jordan.

MENA countries are also impacted by US monetary policy. The main issue is still the combination of a strong U.S. dollar and higher interest rates. On the one hand, MENA countries that are pegged to the U.S. dollar (Jordan, Oman, Qatar, Saudi Arabia, Lebanon...) had to follow the raise in the interest rates knowing that their economies are recording sluggish growth. On the other hand, countries such as Egypt and Tunisia are hit by a strong dollar.

In details, governments and private companies in these countries have benefited from low U.S. interest rates by borrowing in dollars and repaying debt with stronger local currencies. Higher interest rates and strong dollar make these debts more difficult to settle and can lead to defaults in payments.

Slowing growth in China could impart larger-than-expected spillovers to both oil exporters and importers in the MENA regions. This decline in growth may eventually lead to downward pressure on global oil prices, thus negatively impacting fiscal performance and economic activity in oil exporting countries. Moreover the recent slowdown in Chinese investments abroad, particularly those related to the Belt and Road project may hinder trade and economic growth in the region.

Country in Focus

The year 2018 proved to be a challenging year for the Lebanese economy, especially given the long political deadlock revolving around the formation of a government.

The Lebanese private sector continued to suffer from low local and regional demand. The Blom Lebanon Purchasing Managers' Index (PMI) a measure of the activity of the private sector slid from 46.7 in November 2018 to 46.2 in December 2018 and therefore ended 2018 below the average of 46.3 for the year. The PMI readings therefore confirmed our estimate that the implied real GDP growth will not surpass the 1% mark in 2018.

Inflation was fueled by higher housing and energy costs. According to the Central Administration of Statistics (CAS), the average yearly inflation rate rose from 4.44% in 2017 to 6.07% in 2018. In details, the average price of "Housing and utilities" (Housing water, electricity, gas and other fuels) constituting a combined 28.4 % of the CPI, witnessed a yearly rise of 6.81%, on the back of increases in its components. "Owner-occupied" rental costs (grasping 13.6% of this category) and "Water, electricity, gas and other fuels" (grasping 11.8% of this category) rose by 3.83% y-o-y and 10.78% y-o-y, respectively .

Lebanon's real estate (RE) and construction sector activities continued to feel the slump in 2018. According to the data from the General Directorate of Land Registry and Cadastre (LRC), the number of real estate (RE) transactions which may include one or more realties registered an annual decrease of 17.44% % to reach 60,714 transactions by December 2018. As such, the total value of the real estate transactions over the period dropped by a yearly 18.04 % to reach \$8.13B by December 2018. Therefore, the average value per transaction slightly dropped from \$134,950 in 2017 to \$133,977 in 2018.

According to the Orders of Engineers in Beirut and Tripoli, the number of construction permits slumped by 16.37% year-on-year (y-o-y) to stand at 13,801 permits by the end of 2018. The Construction Area Authorized by Permits (CAP) also fell by an annual 23.79% to 9M square meters (sqm), indicating investors' growing interest in smaller construction areas for their projects.

The tourism sector saw high arrivals but not yet the return of heavy spenders from Arab countries. According to the Ministry of Tourism, the number of tourists visiting Lebanon, in 2018, displayed a 5.77% year-on-year (y-o-y) progress, where the total number of tourists went up from 1.86M to 1.96M. This increase is owed to the yearly

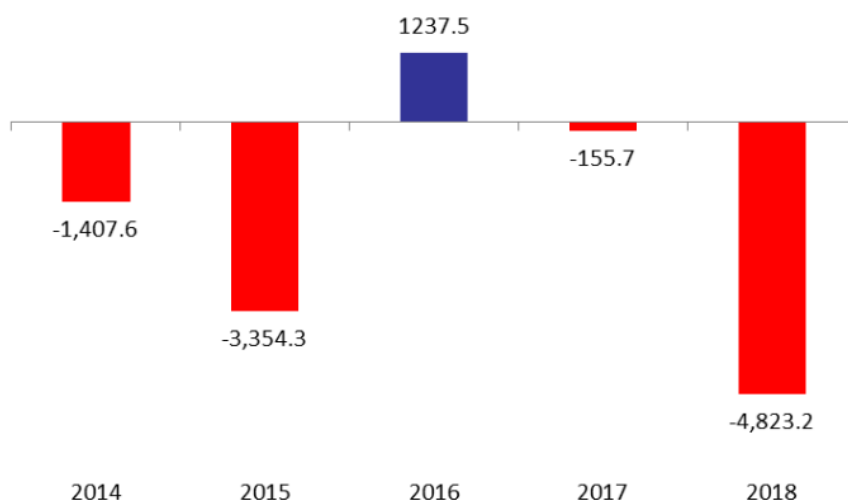
growths recorded in tourist arrivals from Europe and America which together comprised 54.16% of total tourists in Lebanon.

In a geographical breakdown, Lebanon witnessed a growth in the number of European tourists that constituted 35.95% of the total; it grew by 10.37% y-o-y to 705,969 by December 2018 on the back of the rise of the number of tourists from the majority of the European countries. Arab countries, representing 28.64% of all tourists, recorded a slight increase of 0.22% to stand at 562,535 in 2018 on the back of the significant rise in the number of Egyptian incomers from 83,405 in 2017 to 92,173 in 2018 and in the number of Jordanian tourists by 2.04% to stand at 92,920 in 2018. However, this increase wasn't enough to outweigh the plunge in the number of GCC and Iraqi tourists. In details, tourists from the United Arab Emirates, Iraq, Saudi Arabia, and Kuwait decreased by 7.86% to 1,770, 7.82% to 211,589, 2.96% to 61,547 and 1.62% to 40,382 respectively.

Lebanon's balance of payments' deficit widened in 2018. According to the Central Bank of Lebanon, Lebanon's Balance of Payments (BoP) ended 2018 with a \$4.82B deficit compared to a \$155.7M deficit during the same period last year. In fact, the external balance was affected by the political uncertainties and difficult economic situation. In details, the NFAs of the Central Bank and commercial banks dropped by \$2.29B and \$2.53B respectively, over the same period.

In 2018, the Balance was mostly affected by the swap operation engineered in May 2018 between the Ministry of Finance (MoF), Banque du Liban (BDL), and commercial banks which sent the Lebanese Balance of payments (BOP) into a surplus totaling \$448.7M by the end of May. In fact, the surplus was partly driven by the central bank's new classification of its Eurobonds under "foreign assets" for the computation of the BOP. As a result, the \$2.48B rise in the stock of Eurobonds at BDL led to a \$2.16B increase in the central bank's net foreign assets in May.

Lebanon's Balance of Payments by December (in millions of \$)



Source: BDL

The country's finances remained weak in 2018, although data is only available for the first nine months of the year. According to the Ministry of Finance, Lebanon's fiscal deficit expanded from \$2B by September 2017 to \$4.50B by September 2018. In fact, fiscal revenues witnessed an annual increase of 3.16% to reach \$8.67B while the government spending rose by a yearly 26.16% to stand at \$13.18B.

Lebanon's overall primary balance which excludes Lebanon's debt service posted a deficit of \$590.89M, compared to a surplus of \$1.63B by September 2017.

According to the Ministry of Finance, Lebanon's gross public debt reached \$85.13B by the end of the year, adding an annual 7.06% on the back of the rise in both, local currency debt and foreign currency debt. In details, local currency debt (denominated in LBP) grasped a stake of 60.66% of total gross debt and recorded an annual 5.10% rise to stand at \$51.64B by December 2018. Following the same trend, foreign currency debt rose significantly by a yearly 10.23% to settle at \$33.49B, equivalent to 39.34% of Lebanon's gross debt. As for the net public debt, that excludes public sector deposits at commercial banks and BDL, it increased by 9.2% year-on-year to reach \$75.72B by December 2018.

Box: Debt Sustainability Analysis

The issue of debt sustainability is now more relevant than ever. Here we explore two scenarios to assess Lebanon's debt sustainability.

The first scenario is a baseline scenario in which we extend the current trajectory of key variables assuming no reforms are undertaken. In this case, the debt to GDP ratio is expected to swell to 175.6% in 2022. It is worth mentioning that our baseline scenario in this issue of the debt sustainability analysis worsened from our previous estimates as economic growth was revised downwards and as the fiscal deficit is expected to widen.

The second scenario is conservatively optimistic as it assumes sounder fiscal management and the implementation of reforms pledged during the CEDRE conference. In this scenario, we factor in the impact of the pledged funds on economic growth, government revenues and private sector deposits. In this scenario, the debt to GDP ratio would reach 139.7% in 2022.

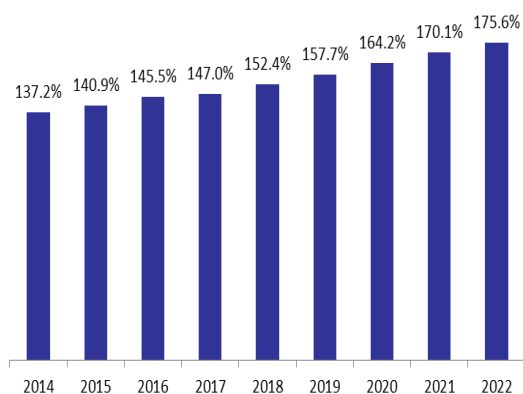
Baseline Scenario

	2016	2017	2018e	2019-2022e
Real GDP Growth Rate	1.74%	1.50%	1.00%	2.2%
Government Revenues	3.6%	17.0%	0.2%	3.0%
Government Expenses	9.9%	3.0%	20.0%	5.0%
Total Deposits	7.2%	3.8%	3.5%	5.0%

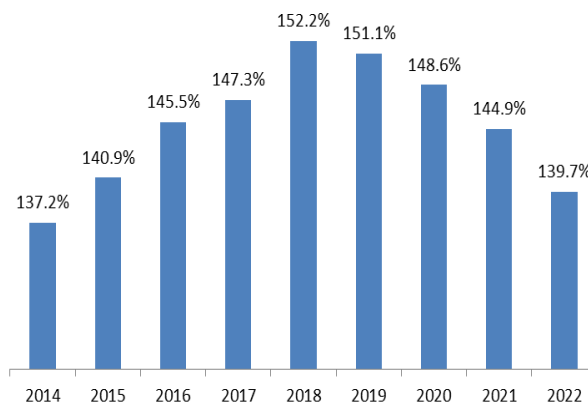
CEDRE + Reforms Scenario

	2016	2017	2018	2019-2022e
Real GDP Growth Rate	1.7%	1.5%	1.0%	2.2%
Government Revenues	3.6%	17.0%	5.0%	6.0%
Government Expenses	9.9%	3.0%	20.0%	5.0%
Total Deposits	7.2%	3.8%	3.5%	5.0%

Debt to GDP Ratio – Baseline



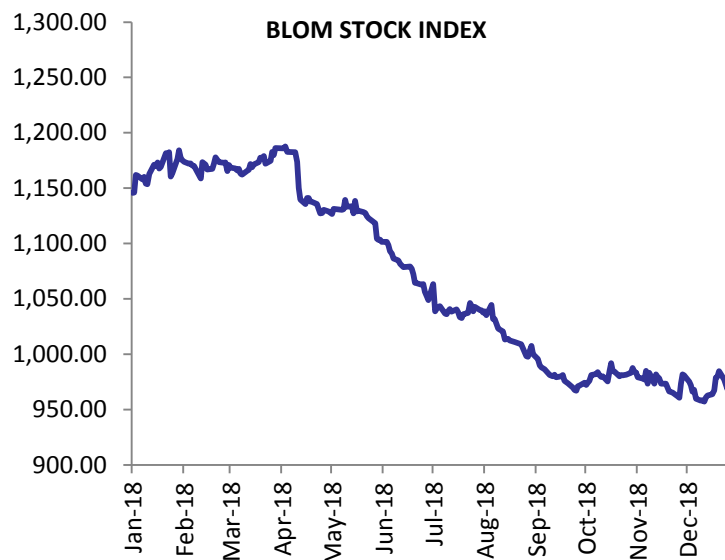
Debt to GDP Ratio – CEDRE+ Reforms

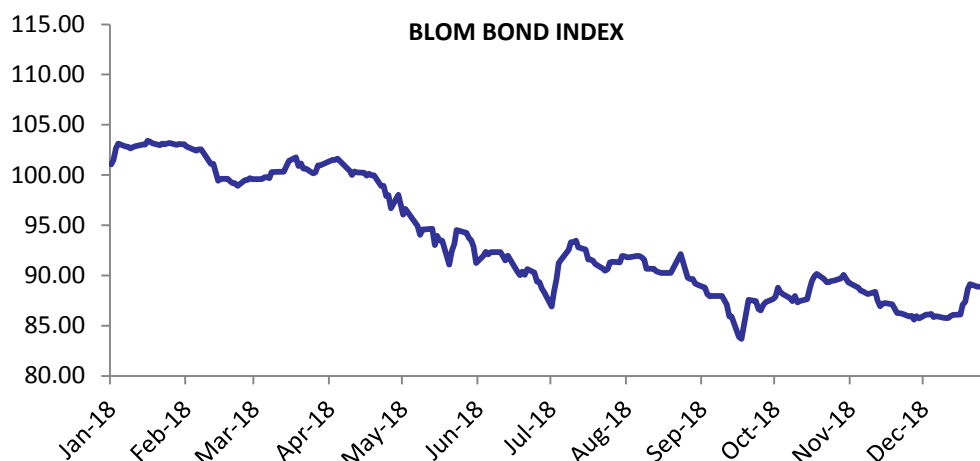


The Central Bank's (BDL's) balance sheet ended the year with an 18.89% year-on-year (y-o-y) increase in its total assets which stood at \$140.60B by the end of 2018. In fact, "Loans to local financial sectors" (23.91% of the total assets) more than doubled rising from \$12.73B last year to \$33.61B this year. Moreover, "BDL's Securities portfolio" (21.93% of total assets) rose by a yearly 5.35% to stand at \$30.83B by December 2018. "Foreign assets" (28.21% of total assets) witnessed a decrease by 5.53% to \$39.67B by December 2018. Meanwhile, "Gold reserves" (grasping 8.37% of total) recorded a downtick by 1.61% y-o-y to \$11.77B.

As for BDL's liabilities, "Financial sector deposits" (85.19% of total liabilities) added 22.87% since year-start to stand at \$119.78B by the end of the year. This is due to the BDL offering banks products with attractive returns. Meanwhile, "Public sector deposits" (3.58% of the total) witnessed a decrease of 14.78% y-o-y to \$5.03B by December 2018.

The extended gridlock around the government's formation put a dent in confidence in 2018. The BLOM Bond Index ended the year down by 12.46% to reach 88.46 points; yields on the Lebanese Eurobonds maturing in 5 and 10 years broke the 7% barrier in early May to climb as high as 11% at the end of the year. The Beirut Stock Exchange also reflected the tough operating environment of 2018 with the BLOM Stock Index declining by 14.90% in 2018 to reach 976.78 points.





The Lebanese Banking Sector

According to Lebanon's commercial banks' balance sheet, total assets witnessed an increase of 13.48% year-to-date (y-t-d) to stand at \$249.48B by December 2018.

In details, deposits with BDL, constituting 52.42% of the total assets, rose by 25.83% to \$130.77B. This was mainly due to the financial engineering implemented by BDL since 2017 offering commercial banks appealing schemes to attract foreign currencies.

Meanwhile, claims on resident customers declined by 3.09% in 2018 to stand at \$51.80B by December 2018. In details, both, the claims on resident customers in Lebanese pound and in foreign currencies observed respective drops of 6.09% and 1.64% during the same period to stand at \$16.33B and \$35.47B, respectively.

Worth mentioning, subscription to Eurobonds increased by a yearly 13.12% to stand at \$16.04B in 2018. Lebanon's Central Bank sold \$3.022 billion of sovereign Eurobonds from its portfolio to commercial banks and financial institutions, following the swap that it conducted with the ministry of finance in May as part of its financial engineering. Meanwhile, subscription to T-bills decreased by a yearly 1.35% to \$17.38B.

On the liabilities side, Resident customers' deposits witnessed an increase of 1.66% y-t-d to reach \$135.45B by December 2018. In details, the 4.92% increase in foreign currencies deposits to \$88.98B offset the 4.03% decrease in deposits in LBP to \$46.48B in 2018.

Non-resident customer's deposits witnessed an increase of 7.31% since the beginning of the year to \$37.73B. The increase took place in both deposits foreign currencies and LBP recording 8.19% and 0.95% to \$33.41B and \$4.31B respectively.

As such, the dollarization ratio of private sector deposits rose from 68.72% in December 2017 to 70.62% in December 2018.

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