



## LEBANON ECONOMIC REPORT

### MODERATE GROWTH IN SECOND HALF-YEAR AFTER NIL GROWTH IN THE FIRST

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- Economy slowing down but avoiding recession**  
 Real GDP is set to have recorded a positive growth of 1% to 2%, though slowing down considerably from the 8% trend of the previous 4 years. The regional turmoil continued impacting private investment confidence, with major investment decisions delayed within an overall wait and see attitude on behalf of private investors at large, while household consumption maintained its sound double-digit growth despite overall political uncertainties.
- Economic conditions in the second half were better than in the first half**  
 It seems that after a "no growth" in the first half-year, the economy reported a moderate growth in the second half subsequent to the cabinet formation and the renewal of BDL Governor's term as suggested by most of the country's real sector indicators. Probably the most comprehensive of those indicators is the coincident indicator of Lebanon's Central Bank and which had grown by merely 1.7% in the first six months of 2011 to rise to 3.3% in the second half-year.
- Monetary conditions relatively favorable since last July**  
 Following net sustained demand on the Lebanese Pound since last July, the Central Bank's foreign currency reserves hit US\$ 30.8 billion at end-December 2011, up by US\$ 2.2 billion since year-end 2010. BDL's foreign currency reserves covered 79% of LP money supply and 18.3 months of imports at end-2011, which underlines the Central Bank's strong ability to defend the currency peg and meet demand for foreign currencies should any pressures arise.
- Moderate banking activity growth along with tougher operating conditions**  
 Bank deposits grew by 7.9% in the year 2011 to reach US\$ 115.7 billion. The US\$ 8.5 billion rise in bank deposits last year, though 26% lower than the corresponding increase in 2010, was sufficient to meet domestic private and public sector financing needs. Within the context of downward pressures on spreads and margins, a relatively lower quantity effect last year and a somewhat stagnating non-interest income base, banks' net profits registered a 3.4% decrease year-on-year in 2011, the first negative growth rate in earnings in nine years.
- Falling equity prices and rising bond spreads on local/regional concerns**  
 The local political tensions and the regional political and security turmoil left their imprints on Lebanese capital markets, triggering a sharp drop in the BSE price index, a sustained low level of turnover ratio and an expansion in bond spreads and the cost of insuring debt. Lebanon's five-year Credit Default Swap spread, which is a measure of market risk perception surged by 167 bps in 2011 to reach 471 bps at end-December. Despite attractive market pricing ratios, the BSE price index fell by 20% in 2011 in a market lacking liquidity and efficiency.
- Macro forecasts for 2012 close to 2011 second half conditions**  
 The Lebanese economy is apt to record a 3% to 4% growth, driven primarily by household consumption which is reporting resilience to the overall environment, while private investment is still subject to the overall wait-and-see attitude with the postponement of major investment decisions. As to inflation, it is expected to rise by an additional 2% relative to the past year as a result of wage adjustment in the private and public sectors to reach circa 8% over the year ahead.
- Economic stability should not occult emerging challenges**  
 The main economic challenge at the horizon is that tied to public finance conditions within the context of the expected rise in government spending and that might reverse the improvement in debt ratios, especially if it is not accompanied by a similar improvement in resource mobilization. Notwithstanding the emerging challenge tied to the deteriorating external balance after the balance of payments reported its first deficit in 10 years amidst rising import prices, stagnation in exports and contracting inflows.

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On the overall, the Lebanese economy went through a considerable slowdown in 2011 but seems to have avoided a recessionary environment or a net contraction in the real economy. According to IMF, real output is set to have recorded a positive growth of 1% to 2%, though slowing down considerably from the 8% trend of the previous 4 years. The quantity theory of money supports the slow growth assumption in 2011. The average yearly increase in Money Supply (5.5%) was coupled with a net contraction in velocity (-2.6%), leaving an average price inflation of 5.7% and a slow output growth. As a matter of fact, the regional turmoil continued impacting private investment confidence, with major investment decisions delayed within an overall wait and see attitude on behalf of private investors at large, while household consumption maintained its sound double digit growth despite overall political uncertainties.

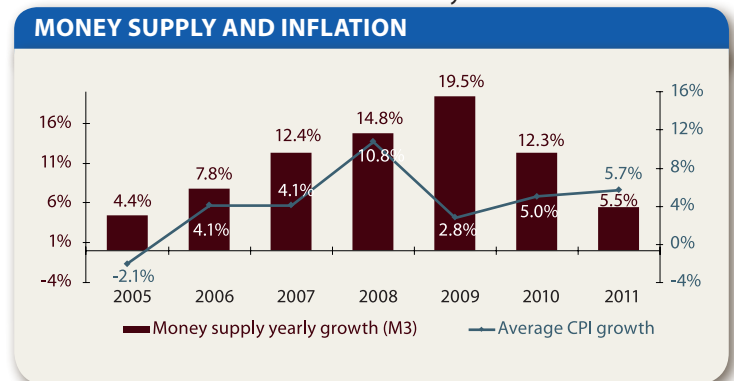
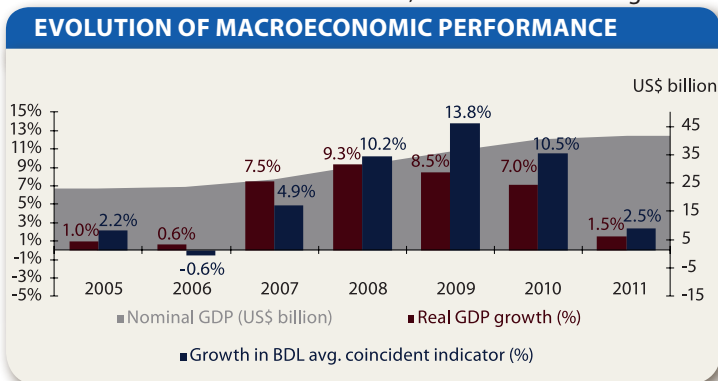
But economic conditions in the second half of 2011 proved to be relatively better than those prevailing in the first half of the year. It seems that after a “no growth” in the first half, the economy reported a moderate growth in the second half in the aftermath of the cabinet formation and the renewal of BDL governor’s term, as suggested by most of the country’s real sector indicators. Probably the most comprehensive of those indicators is the coincident indicator of Lebanon’s Central Bank and which had grown by merely 1.7% in the first six months of 2011 to rise to 3.3% in the second half-year.

The analysis of individual real sector indicators confirms the discrepancy in economic growth between the first half-year and the second half-year. The merchandise at the Port which dropped by 1.3% in the first half-year, expanded by 7.9% in the second half-year. Likewise, the value of property sales rose by 4.7% in the second half, after having dropped by 18.3% in the first half. The delivery of cement reported growth rates of 2.9% and 9.4% in the consecutive half-year periods. Cleared checks, a reflection of private spending in both its consumption and investment spending components, stagnated in the first half and grew by 13.7% in the second half. Only the number of tourists contracted significantly in both half-years (-19.7% and -26.8% respectively), as a considerable part of Arab visitors by land refrained from coming to Lebanon in view of the Syrian security situation.

At the external sector level, the growth in imports by 12% driven by a growing import bill along with the stagnation in exports in view of unrest in a number of neighboring recipient countries, lead to a considerable surge in the trade deficit to US\$ 16 billion in 2011 exceeding for the first time in a decade the inflows towards the home economy. This added to a decline in financial inflows by 18.4% over the year amid domestic and regional concerns, the balance of payments reporting a deficit of US\$ 2 billion in 2011, the first deficit of its kind since 2002.

The deceleration of inflows actually weighed down on banking growth, with customer deposits posting an increase of US\$ 8.5 billion during the year, versus a rise of US\$ 11.4 billion in 2010. The growth at the foreign currency side was yet more significant than the one realized over the previous year, bearing in mind that foreign currencies account for the core of financing to the economy, as revealed by the substantial loans to the private sector which grew by US\$ 4.4 billion since the beginning of the year. The slowdown in activity growth was actually coupled with downward pressures on spreads and interest margins within a historically low interest rate environment leading to a 3.4% net contraction in bottom lines.

Such developments in the different economic sectors of activity are actually detailed in the sections that follow, while the concluding remarks are left to the overall macro outlook for the year ahead.





## 1. ECONOMIC CONDITIONS

### 1.1. REAL SECTOR

#### 1.1.1. Agriculture and Industry

##### *Stagnation in foreign demand of domestic goods*

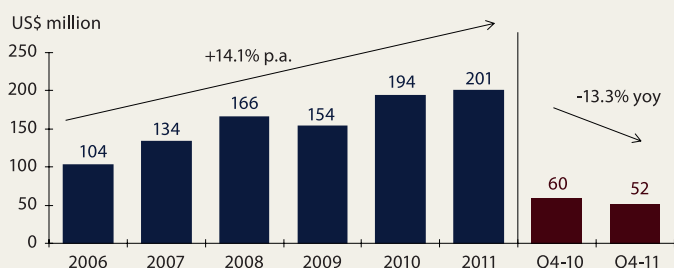
The activity of the primary and secondary sectors was relatively slow in 2011 due to the local political stalemate during the first half of 2011 and the regional political turmoil. Foreign demand on primary and secondary sectors output witnessed a relative stagnation in 2011 as the aggregate value of agricultural and industrial exports rose by a mere 0.3%, while domestic demand remained more or less satisfactory as the aggregate value of agricultural and industrial imports grew by 12.2% year-on-year despite the prevailing slow economic growth.

The agricultural sector witnessed a slow growth in activity with respect to its external component as a result of the regional political unrest. Lebanon's agricultural exports amounted to US\$ 201 million in 2011, up by 3.6% relative to 2010, according to the Higher Customs Council. This compared to a much higher growth of 26.0% in 2010. Still, the agricultural exports' share of total exports remained stable year-on-year, moving up slightly from 4.6% in 2010 to 4.7% in 2011. On the other hand, Lebanon continued to import an important proportion of its agricultural products, with these imports amounting to US\$ 1.9 billion in 2011, more than 9 times the value of agricultural exports, and up by 10.6% relative to the year 2010. Accordingly, the agricultural trade deficit reached US\$ 1.7 billion in 2011, exceeding the US\$ 1.5 billion deficit of 2010 and up by 11.5%.

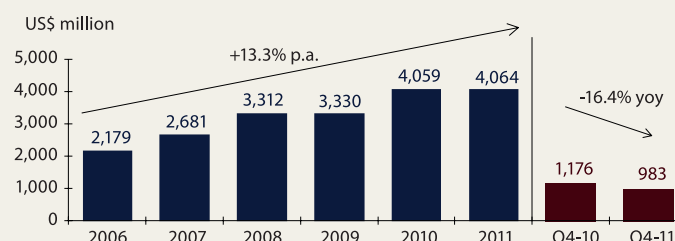
In parallel, the secondary sector witnessed stagnation in its activity during the year 2011. Industrial exports totaled US\$ 4,064 million in 2011, up by a mere 0.1% relative to 2010. On the other hand, Lebanon's imports of industrial machinery reached US\$ 198.6 million in the first ten months of 2011, up by 1.4% relative to the corresponding period of 2010. The value of imports of industrial machinery, which indicates the activity of investments made in the industrial sector, shows sluggishness in industrial investment activity within the context of slowdown in economic growth in the country. The distribution of imported industrial machinery by country of origin in the first ten months of 2011 reveals that Italy was the largest exporter of industrial machinery to Lebanon with exports worth US\$ 60.0 million and accounting for about 30.2% of the total. It was followed by Germany with US\$ 29.4 million (14.8%), China with US\$ 28.7 million (14.4%), Turkey with US\$ 14.1 million (7.1%), the United States with US\$ 13.5 million (6.8%), and France with US\$ 9.8 million (4.9%).

In sum, activity in the primary sector in Lebanon witnessed some growth, though limited, while activity in the secondary sector remained stagnant. This performance of the agriculture and manufacturing sectors could show progress in the event of an improvement in local political conditions that would fuel investments and in the case of an improvement in regional political conditions and alleviation of uncertainties in a way that would revive Lebanese exports at large.

#### AGRICULTURAL EXPORTS



#### INDUSTRIAL EXPORTS





## 1.1.2. Construction

### *Drop in property market activity but prices maintain stability*

The property sector has slowed down in Lebanon in 2011, with a downward correction in activity and sales volumes on the overall despite the slight improvement in the last quarter of the year. The value of property sales dropped by 7% in 2011 and the number of sales transactions contracted by 11.9% over the year. With sales to foreigners in particular contracting by 20.3%, it looks like foreign demand and more particularly Arab demand is the one to have reported the most acute decline, notwithstanding the slowdown of demand from Lebanese non-residents. The correction in the market volumes is tied to a number of factors, namely the domestic political bickering and regional turmoil creating uncertainties for investors on one hand and the large base of property sales reached in the previous year after four consecutive years of double digit growth in the market.

On the supply side, the construction sector has also witnessed a deceleration in its levels of activity. In fact, the drop in demand triggered a wait-and-see mood in the market and prompted developers to take more time to launch new projects, noting that the new housing stock coming to the market consisted of projects developers launched over the past couple of years. Figures released by the Order of Engineers in Beirut and Tripoli reveal that the area of newly issued construction permits reached 16.4 million square meters in 2011, down by 6.8% year-on-year. This drop compares to a significant 23.0% growth in 2010. The latest statistics from the Central Bank of Lebanon showed that cement deliveries, a coincident indicator of construction activity, rose by 6.2% to reach 5,550 thousand tons in 2011.

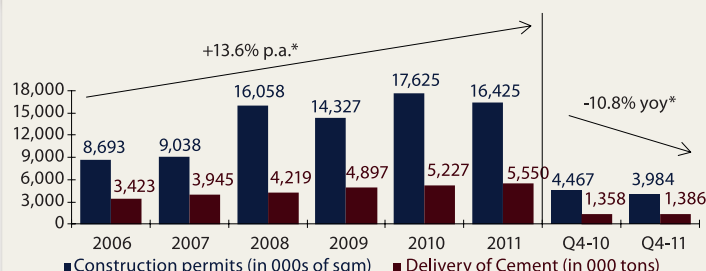
It is also important to mention that the correction in volumes is not being coupled with a correction in market prices. Property prices remained almost flat, with very minor changes (downward or upward) depending on the region. The resilience of the property prices is tied to a number of factors: The limited supply of land in a small area size countrywide, the lack of speculative demand with most of the past years demand being driven by end-user needs and the low leverage of developers that are not under significant pressure to ratify sales. All such factors support the argument that there is no real estate bubble in Lebanon but some correction in an overall cloudy regional environment.

Having said that, the growing gap between the purchasing power of residents and prices of housing stock in the capital city, and, more recently, its immediate suburbs, has impacted demand for new housing in these areas and shifted it to smaller flats, the most in demand being those with a total size ranging between 100 and 250 square meters per apartment. As such, developers had to get accustomed to a new demand patterns and launch new projects with a smaller apartment size. Also, more and more buyers are turning to the outskirts of Beirut, where prices remain somehow more affordable and suitable for households budgets and which are seeing growing market shares at the detriment of those in the capital city.

### CONSTRUCTION

					Variation	
	2010	2011	Q4-10	Q4-11	11/10	Q4/Q4
Value of property sales (in millions of US\$)	9,479	8,841	2,517	2,808	-6.7%	11.6%
Number of property sales	94,202	82,984	24,701	25,008	-11.9%	1.2%
o.w. Sales to foreigners	1,920	1,530	519	562	-20.3%	8.3%
Average value per property sale (US\$ 000)	101	107	102	112	5.9%	10.2%
Property taxes (in millions of US\$)	613	603	160	181	-1.6%	13.1%

### EVOLUTION OF CONSTRUCTION INDICATORS



\* Related to construction permits figures



### 1.1.3. Trade and Services

#### *Slowdown in tertiary sector activity year-on-year*

The local political tensions and the widespread regional political disturbances left their imprints on the performance of the trade and services sector in 2011. Tourism activity contracted after vibrant years in 2009 and 2010. In fact, Lebanon was not able to build on the opportunity of redirected regional tourism following the politico-security developments in a number of regional countries, due to its domestic political developments and the worsening of the situation in Syria and its impact on the incoming travelers from regional countries.

The aggregate number of tourists fell by 23.7% to reach 1,655,051 in 2011, versus 2,167,989 in 2010, noting that this decrease was the first seen since the year 2006. The distribution of tourists by origin in 2011 indicates that the majority of visitors were from Arab countries with 35.1% of aggregate visitors, followed by visitors from Europe with 29.3%, visitors from Asia with 14.8%, visitors from the Americas with 13.5%, visitors from Africa with 3.7% and visitors from Oceania with 3.4%.

In parallel, airline activity in Lebanon slowed down in 2011, as demonstrated by a small rise in the number of passengers and a fall in the number of planes at the airport. In fact, the number of airport passengers (arrivals, departures, transit) totaled 5,654,752 in 2011, up by 1.9% from 2010. This compares to a higher yearly growth of 11.3% in 2010. Aircraft traffic at the airport saw a yearly drop of a 3.7% to 63,667 planes.

Subsequently, the declining tourism activity in the country took its toll on Beirut's hotel sector. As a matter of fact, hotel occupancy in Beirut reached 57% in 2011, down by 11% relative to the previous year, as per Ernst & Young. The average room rate in Beirut hotels reached US\$ 220 for 2011, posting a yearly decline of 13.7% from US\$ 255 in 2010. The drop in hotel occupancy, coupled with a fall in the average room rate, has led to a decrease in the rooms' yield. Indeed, the rooms' yield of Beirut's hotels attained US\$ 126 in 2011, down by 27.6% from 2010, indicating that the hotel sector has been negatively impacted by the local political situation and the regional turmoil.

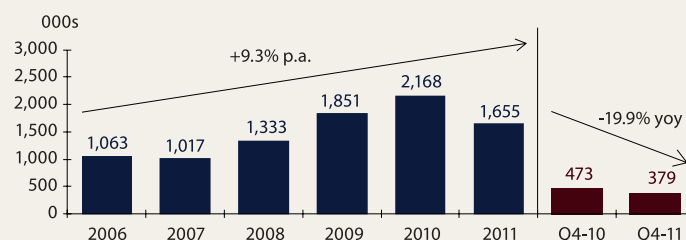
The spending patterns of tourists in Lebanon reported a positive growth. Figures released by Global Blue revealed that tax-free purchases grew by a yearly 8% in 2011. Yet, de-taxed purchases saw their growth dropping relative to the 21% growth recorded in 2010. The distribution of expenditures of tourists in Lebanon by country of origin shows that the majority of spenders in Lebanon were Arabs. Aggregate spending of nationals from Saudi Arabia, the UAE, Kuwait, Syria and Egypt accounted for 55% of total tourist spending in Lebanon in 2011.

As to other indicators mirroring the performance of the trade sector, maritime transport witnessed mixed trends in 2011. The total tonnage of loaded and unloaded merchandise at the Port of Beirut went up by a yearly 3.2% in 2011 to reach 6,677 thousand tons. The number of containers at the port (excluding transshipments) decreased by a yearly 2.4% to attain 585,220 containers in 2011. In parallel, the number of ships declined by 5.2% and amounted to 2,167. As for revenues generated by the port, they reached US\$ 158.8 million in 2011, depicting a yearly 4.8% drop relative to 2010. Finally, as a reflection of private spending, the value of cleared checks in the banking system grew by 6.9% in 2011, compared to a much higher growth of 19.6% in 2010.

#### TRADE AND SERVICES

	2010	2011	Q4-10		Q4-11		Variation	
			Q4-10	Q4-11	11/10	Q4/Q4		
Number of ships at the port	2,285	2,167	535	519	-5.2%	-3.0%		
Number of containers at the port (in 000s)	599	585	141	146	-2.4%	3.4%		
Merchandise at the Port (in 000 tons)	6,469	6,677	1,555	1,652	3.2%	6.2%		
Planes at the Airport	66,122	63,667	16,760	15,690	-3.7%	-6.4%		
Number of passengers at the Airport (excluding transit)	5,510,214	5,596,214	1,296,804	1,352,122	1.6%	4.3%		
Growth in de-taxed purchases	21%	8%	-	-	-13.0%	-		
Cleared checks (in millions of US\$)	67,432	72,103	16,523	18,368	6.9%	11.2%		

#### EVOLUTION OF NUMBER OF TOURISTS





## 1.2. EXTERNAL SECTOR

### 2011 foreign trade activity burdened by tougher external environment

Lebanon's external sector activity in 2011 was somewhat burdened by regional politico-security conditions and rising oil prices. The volume of foreign trade, as per the Higher Customs Council, increased by 9.9% in 2011, against a higher rate of 12.6% during 2010, with imports sustaining a growth stance and exports slowing down significantly. As such, the export-to-import ratio fell from 23.7% in 2010 to 21.2% in 2011. Consequently, the trade deficit widened to US\$ 15.9 billion in 2011, up by 15.9% from 2010.

In details, exports amounted to US\$ 4.3 billion in 2011, remaining practically flat from 2010, year during which they had increased by 22.1%. In fact, the ongoing regional unrest in several Arab countries has somewhat taken a toll on demand for Lebanese exports to the main regional markets, namely Iraq, Syria, and Egypt which account all together for 12% of the total. Exports to Egypt posted a contraction of 66% during 2011 subsequent to an increase of 169% seen in 2010. Products directed to Syria also went down by a yearly 3%, while the trade linkages to other countries surrounding it remained secured in 2011. Exports to Iraq dropped by 26% during 2011 compared to a lower contraction of 6% in 2010.

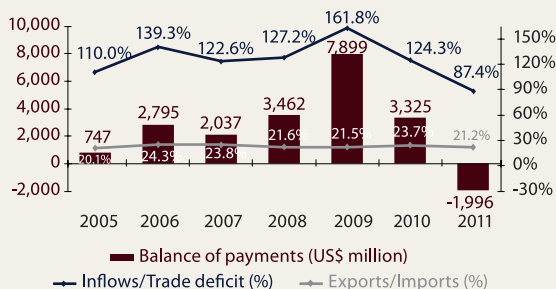
The breakdown of exports by country of destination indicates that Switzerland was the major receiver of Lebanese products with 12.1% of the total. It was followed by the UAE with 7.5%, Saudi Arabia with 7.2%, Turkey with 6.5%, and Syria with 5.0%. Lebanon's primary export item in 2011 was jewelry, which accounted for 35.0% of total exports. It was followed by metals and metal products with 12.3%, and electrical equipment and products with 12.2%.

As to imports, their value increased by 12.2% to US\$ 20.2 billion, but carried with it an inflationary effect. It is worth noting that imports of consumer products grew by 22.3%, versus a growth of 16.2% in 2010, thus revealing somewhat resilient consumption trends. Conversely, imports of investment goods rose by a mere 0.3% in 2011 down from 4.6% in 2010, revealing hesitancy from investors to initiate new projects due to spillover fears from neighboring countries.

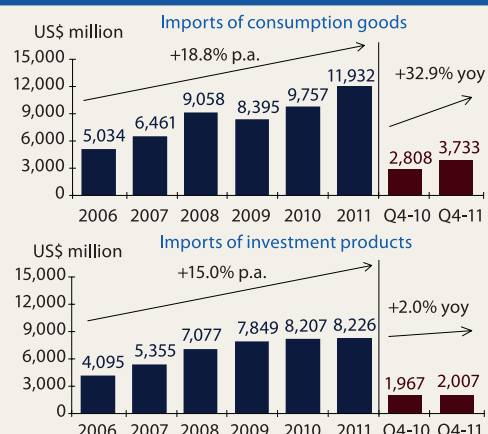
The breakdown of imports by country shows that the US was the major exporter to Lebanon with 9.9% of the total, followed by Italy with 9.3%, China with 8.1%, and France with 7.5%. Lebanon's primary import item in 2011 was mineral products which accounted for 22.9% of total imports. It was followed by electrical equipment and products as well as jewelry with a practically equal share of 10.6%.

Based on foreign trade statistics, gross financial inflows dropped by 18.4% in 2011, reaching US\$ 13,897 million in 2011. The deceleration in financial inflows to Lebanon during 2011 was mainly attributed on one hand to the fall in tourist arrivals leading to lower influx of foreign currency and on the other hand to the lack of foreign investment appetite due to regional political tensions. As such, the balance of payments posted a deficit of US\$ 1,996 million in 2011, against a surplus of US\$ 3,325 million a year earlier, the first such deficit in nearly a decade.

### FOREIGN SECTOR INDICATORS



### IMPORTS OF CONSUMPTION/INVESTMENT PRODUCTS





### 1.3. PUBLIC SECTOR

*Debt-to-GDP ratio sustains downward trend though at a relatively slower pace*

The latest figures released by the Ministry of Finance revealed that the fiscal deficit during the first 11 months of 2011 amounted to US\$ 1,950 million, equivalent to 18.8% of total expenditures. Total revenues reached US\$ 8,445 million over the aforementioned period of 2011 while total expenditures attained US\$ 10,395 million. Excluding telecom transfers (only one of which was made in the previous year), the 11M2011 fiscal revenues would drop to US\$ 7,124 million and consequently, the fiscal deficit would rise to US\$ 3,271 million. As to the primary surplus, which excludes debt service, it totaled US\$ 1,735 million over the first 11 months of 2011.

On the revenues side, those stemming from budget transactions accounted for 95% of the total while the remainder came from Treasury transactions. In details, budget revenues stood at US\$ 8,031 million, of which 75% originated from tax revenues and 25% from non-tax revenues. Tax revenues declined by 1.5% on the back of a generally slower economic activity prevailing throughout the covered period of 2011. In fact, VAT revenues which totaled US\$ 2,041 million rose by a slight 2.6% during the first 11 months of 2011 versus last year's increase of 10.9%, while custom revenues, at US\$ 1,325 million, posted a yearly decline of 22.7%. As to non-tax revenues, they have taken into account those coming from the Ministry of Telecommunications, amounting to US\$ 1,321 million, while such transfers were made only once in 2010 (in February 2010 with US\$ 220 million). As to revenues classified under Treasury transactions, they reached US\$ 414 million over the first 11 months of 2011, up by 2.3% year-on-year.

On the expenditures side, as the government was appointed since the middle of the year only, it did not have the opportunity to enact significant spending programs. As a result, total public expenditures increased by a slight 1.1% during the first 11 months of 2011 with 92% allocated to budget expenditures and the remainder to Treasury expenditures.

In details, budget expenditures stood at US\$ 9,571 million, 61.5% of which was allocated to general budget expenditures and 38.5% to interest payments and foreign debt principal repayment. Outlays related to the national electricity company equaled US\$ 1,557 million, up by 46.9% year-on-year, on account of higher average oil prices. Interest payments witnessed a 3.4% decline to US\$ 3,466 million, noting that both domestic and foreign debt servicing fell over the first 11 months of 2011 as a result of the renewal of maturing Tbs and bonds relatively lower rates. Foreign debt principal repayment edged up by a yearly 9.2% over the said period of 2011 to reach US\$ 218 million.

Moving on to financing measures of the government, Lebanon's gross public debt reached US\$ 53.6 billion at the end of December 2011, up by 2.0% from end-2010. Local currency debt rose by 2.2% to US\$ 32.7 billion at end-December 2011 while foreign currency debt increased by 1.7% to US\$ 20.9 billion. There has been a notable improvement in the indebtedness ratio as it sustained a downward path from a peak of 180% in 2006 to 133% in 2011. At a time of rising concerns over sovereign related debt woes across the world's most advanced economies, Lebanon, which continues to suffer from fiscal evasion gap of circa 7% of GDP and low resource mobilization, should henceforth work on optimizing fiscal policy, and in particular revenue generation, in order to pave the way for a further decline in its still elevated indebtedness ratios by global standards.

#### PUBLIC SECTOR

in millions of US\$	11M 2010 Vol	11M 2011 Vol	Progression Vol
<b>Deficit financing</b>			
Deficit	2,860	1,950	-910
State creditor accounts	-127	379	506
Other items	-2,057	-866	1,191
<b>Uses=sources</b>	<b>676</b>	<b>1,463</b>	<b>787</b>
<b>LP</b>	<b>1,047</b>	<b>965</b>	<b>-82</b>
Treasury bills (banking system)	827	1,116	289
Others	220	-151	-371
<b>FX</b>	<b>-371</b>	<b>498</b>	<b>869</b>
Sovereign eurobonds (including Paris II bonds)	-164	709	873
Others	-207	-211	-4

#### PUBLIC INDEBTEDNESS





## 1.4. FINANCIAL SECTOR

### 1.4.1. Monetary Situation

#### *Stable interest rates at record low levels*

Despite a relatively favorable second half-year, the year 2011 on the overall recorded net conversions in favor of foreign currencies, contraction in LP money supply, stability in interest rates and a rise in the Central Bank's foreign currency reserves.

While some currency conversions in favor of the Lebanese Pound occurred in the second half-year, and allowed the FX market to maintain a relatively balanced activity towards the end of the year, the year 2011 saw net conversions in favor of foreign currencies of about US\$ 2.25 billion. The Lebanese Pound remained pegged to the US Dollar at a rate of LP 1,507.5/US\$, buttressed by the high level of the BDL's foreign reserves. The Central Bank's foreign currency reserves hit US\$ 30.8 billion at end-December 2011, up by US\$ 2.2 billion since year-end 2010. BDL's foreign currency reserves covered 79.2% of LP money supply and 18.3 months of imports at end-2011, which underlines the Central Bank's strong ability to defend the currency peg and meet demand for foreign currencies should any pressures arise.

On the back of net conversions in favor of foreign currencies, LP money supply contracted by LP 759 billion (the equivalent of US\$ 503 million) in 2011. This compares to an expansion of LP 7,913 billion during 2010 (the equivalent of US\$ 5,249 million). When adding foreign currency deposits, money supply in its broad sense (M3) grew by US\$ 5,085 million or 5.5% in 2011. This expansion compares to a money creation of US\$ 3,447 million that resulted from a US\$ 1,347 million increase in the State's indebtedness towards the banking system (excluding valuation adjustments) and from an increase of US\$ 4,202 million in net bank lending to the private sector, within the context of a negative change in net foreign assets (excluding gold) of US\$ 2,102 million. The difference between the growth in money supply and money creation amounting to US\$ 1,638 million corresponds to a monetization of financial claims over 2011.

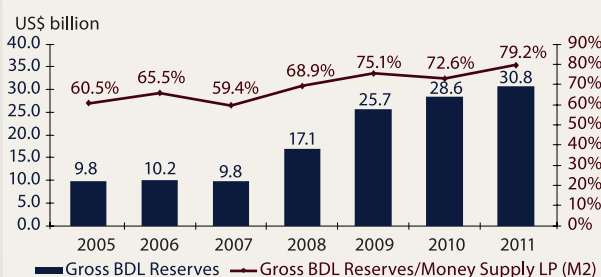
The Central Bank of Lebanon and the Ministry of Finance conducted three swap operations in 2011. After executing a swap operation in March between LP CDs and the 7.90% LP seven-year Tbs for an amount of LP 1,760 billion, the monetary authorities concluded in April a voluntary swap between LP Tbs maturing between 28th of April and 30th of June 2011, and the 7.90% LP seven-year category for an amount of LP 2,600 billion. The Ministry of Finance launched in September 2011 seven-year Tbs with a yield of 7.60% that attracted subscriptions in cash in addition to a swap with LP Certificates of Deposits for a total amount of LP 1,966 billion.

As far as interest rates are concerned, the overnight LP lending rate maintained its low official level of 2.75% in 2011. Likewise, interest rates on LP Treasury bills remained stable, with the average yield on the three-month category standing at 3.93% at end-2011, and the average yield on the six-month category edging down by two bps to 4.50%. The average yield on the one-year, two-year, three-year and five-year categories remained unchanged, standing at 4.81%, 5.34%, 5.94% and 6.18% respectively. The stability in LP policy rates followed consecutive drops in recent years to reach their current historic lows.

#### MONETARY SITUATION

Flows in US\$ million	2010 Vol	2011 Vol	Progression Vol
Net foreign assets (excluding gold)	3,297	-2,102	-5,399
Net claims on the public sector (excluding valuation adjustments)	919	1,347	428
Net claims on the private sector	6,224	4,202	-2,022
<b>Uses=Sources</b>	<b>10,440</b>	<b>3,447</b>	<b>-6,993</b>
Money (M3)	10,068	5,085	-4,983
Valuation adjustment and other items	372	-1,638	-2,010

#### EXCHANGE MARKET INDICATORS



## 1.4.2. Banking Activity

### *Satisfactory lending activity growth underpinned by banks' strong financial flexibility*

The Lebanese banking sector witnessed a moderate activity growth during the year 2011, notwithstanding a difficult operating environment marked by domestic political tensions, especially during the first half-year, and concerns over drifts in neighboring countries. Measured by the total assets of banks operating in Lebanon, sector activity progressed by 9.0% during the past year to reach US\$ 140.6 billion at end-December 2011, against a slightly higher yearly growth rate of 11.9% in the previous year.

Banking sector activity over the year 2011 continued to be driven by customer deposits, which constitute the major source of funding for Lebanese lenders. Bank deposits grew by 7.9% in the year 2011, progressing from US\$ 107.2 billion at end-December 2010 to US\$ 115.7 billion at end-December 2011. The US\$ 8.5 billion rise in bank deposits last year yet proved 26% lower than the corresponding volume increase over the year 2010 marked by relatively more stable domestic and regional politico-security conditions.

The analysis of bank deposits by currency shows that the year 2011 increase was almost entirely accounted for by rising foreign currency deposits, the equivalent of US\$ 8.5 billion volume wise. Local currency deposits stagnated when comparing year-end 2011 with the previous year. Within the context of non-negligible conversions to the benefit of foreign currencies towards the early part of the year amidst rising domestic political tensions, the local currency deposit base renewed with positive growth as of the second half of the year, along with a relative easing of the domestic political situation. In fact, with the FX market activity turning anew in favor of the Lebanese Pound as of the second half-year, the rise in the domestic deposit base during 2H2011 was accounted for by an increase in local currency deposits to the extent of 56%. Though decreasing slightly from a near two-year high during the second half of the year, the deposit dollarization ratio reached 65.9% at end-December 2011, rising from 63.2% at end-December 2010.

Resident deposits accounted for two thirds of 2011's increase in Lebanese banks' deposit base, with a US\$ 5.7 billion, or 6.5%, yearly rise. The non-resident sector accounted for the remaining third, registering a 15.0% increase in deposits during 2011, the equivalent of a US\$ 2.8 billion rise. Non-resident deposits actually represented 18% of the total domestic deposit base at end-December 2011.

The rise in bank deposits in 2011 was sufficient to meet all the domestic financing needs at the level of both private and public sector financing. In fact, bank lending to the private sector was healthy last year, driven by banks' strong financial flexibility and high liquidity. Apart from a low loan/deposit ratio (a mere 34%), primary liquidity ratios remain far above regional and international benchmarks, accounting for nearly half of customer deposits.

### BANKING ACTIVITY

in millions of US\$	2010					2011					Q4/Q4	11/10
	Q1	Q2	Q3	Q4	2010	Q1	Q2	Q3	Q4	2011		
Var: Total assets	4,663	1,767	5,063	2,182	13,675	3,562	2,942	2,993	2,153	11,651	-1.3%	-14.8%
% change in assets	4.0%	1.5%	4.2%	1.7%	11.9%	2.8%	2.2%	2.2%	1.6%	9.0%	-0.1%	-2.9%
Var: Total deposits	2,369	1,987	3,731	3,350	11,437	942	3,337	1,909	2,322	8,511	-30.7%	-25.6%
o.w. LP deposits	1,995	1,475	1,373	529	5,373	-2,491	131	1,215	1,168	23	120.8%	-99.6%
o.w. FC deposits	374	512	2,358	2,821	6,065	3,433	3,206	694	1,154	8,487	-59.1%	39.9%
% change in total deposits	2.5%	2.0%	3.7%	3.2%	11.9%	0.9%	3.1%	1.7%	2.0%	7.9%	-1.2%	-4.0%
Var: Total credits	2,339	997	2,110	1,109	6,555	1,504	822	1,506	613	4,446	-44.7%	-32.2%
o.w. LP credits	537	667	618	529	2,351	308	530	401	379	1,618	-28.4%	-31.2%
o.w. FC credits	1,802	330	1,492	581	4,204	1,196	292	1,105	234	2,827	-59.7%	-32.8%
% change in total credits	8.2%	3.2%	6.7%	3.3%	23.1%	4.3%	2.3%	4.0%	1.6%	12.7%	-1.7%	-10.4%



Within a historically low interest rate environment and negative carry on their primary liquidity, Lebanese banks extended new waves of loans to the private sector for a considerable US\$ 4.4 billion. Although such a figure is 32% below the US\$ 6.6 billion growth realized in the previous year, it is actually deemed as quite healthy bearing in mind the relatively difficult operating conditions on the back of domestic uncertainties and regional turmoil, and remains 15% above the average lending growth of the past five years.

Foreign currency loans continued to drive lending activity in 2011 with a 64% share in lending growth. In parallel, LP loan growth, supported by BDL's reserve exemption measures, maintained a contribution to total lending activity growth close to those of the years 2009 and 2010 at about one third of the total, a high compared to the previous few years (during which that share did not exceed 10%-15%). As a result, the loan dollarization ratio continued to pursue a slight downward trajectory to reach its lowest level in more than two decades (78.4% at end-December 2011).

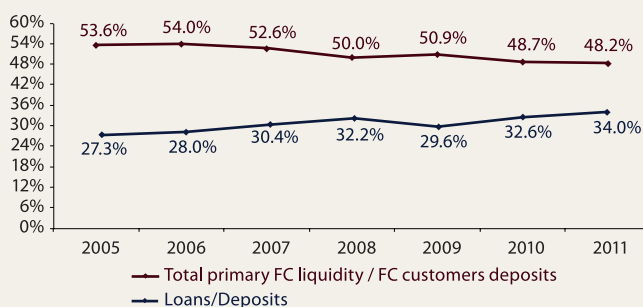
The full-year 2011 lending activity growth was mostly accounted for by the resident sector, with a US\$ 3.9 billion rise equivalent to an 88% contribution to new loans extended by Lebanese banks. Loans to non-residents also registered a positive variation (+US\$ 537 million) during 2011, though retreating during the last quarter of the year amidst deteriorating political conditions in neighboring countries and banks' generally increased cautiousness with regards to lending on the back of tough global credit market conditions.

The additional growth in banks' lending portfolios last year did not come at the expense of asset quality. In fact, Lebanese banks' doubtful loans/total loans ratio reached a decade low of 3.5% at end-December 2011 (3.9% at end-December 2010) and compares favorably to regional and international averages. Provisioning levels remain adequate, with the ratio of provisions to doubtful debt at 77.0% at end-December. Also, Lebanese banks remain adequately capitalized, with a Basle II capital adequacy ratio close to 12% exceeding requirements.

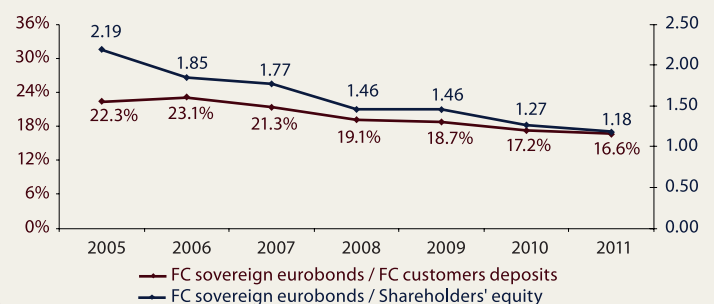
Along the same lines, Lebanese banks have been reporting a relative decline in State exposure. Although the domestic exposure to sovereign debt still weighs on Lebanese banks' activity profile, it has been on a relatively declining trend in recent years. The aggregate portfolio of foreign currency sovereign bonds held by banks reached 118.2% of their equity base at end-December 2011, down from 126.8% at end-December 2010 and registering a notable improvement from levels exceeding the 200% mark a scant few years ago, thus bearing witness to a gradually improving trend over the past decade.

At the level of profitability, interest margins came under considerable pressure in 2011 as a result of a negative carry on primary liquidity in foreign currency on one hand and the renewal of LP Tbs maturities held by banks at much lower yields. The negative carry on primary liquidity is the result of the spread between the average cost of FC deposits (2.84%) and the average US\$ 3-month Libor (0.34%) within a historically low interest rate environment. On the Lebanese Pound side, banks have renewed their LP Tbs maturities at 2% less than initial subscription yields, while the cost of LP deposits barely declined by 30 bps over 2011. Within the context of downward pressures on spreads and margins, a relatively lower quantity effect last year and a somewhat stagnating non-interest income base reflecting a slowing down private spending, banks' net profits registered a 3.4% decrease year-on-year in 2011, the first negative growth rate in earnings in nine years, leading to a contraction in return ratios.

### BANKS LIQUIDITY STANDING



### BANKS SOVEREIGN EXPOSURE



### 1.4.3. Equity and Bond Markets

#### *Drop in equity prices and expansion in bond spreads on local/regional concerns*

The local political tensions during the first half of 2011 and the widespread political and security turmoil that shook the region left their imprints on Lebanese capital markets over the year 2011, triggering a sharp drop in the BSE price index, a sustained low level of turnover ratio, and an expansion in bond spreads and the cost of insuring debt. In fact, regional political instability deterred fresh foreign investments in the Eurobond market during the year 2011, while the European debt woes prompted existing foreign market players to sell their Lebanese holdings to cover losses in international markets. In parallel, local investors exhibited a healthy demand for Lebanese debt papers in 2011, on the basis of high foreign currency primary liquidity available at commercial banks that reached circa US\$ 37 billion at end-December 2011.

All in all, the Lebanese average yield increased moderately by 30 bps to reach 4.42% at end-December 2011. The average bond spread widened by a significant 139 bps to reach 321 bps due to a rise in Lebanese yields and a sharp drop in international benchmark yields as the US Treasuries benefited from their safe haven status amid lingering concerns about the European debt crisis and the global economic outlook. Lebanon's five-year Credit Default Swap spread, which is a measure of market risk perception, surged by 167 bps in 2011 to reach 471 bps at end-December, mainly driven by concerns over the regional political developments and their repercussions on the local front.

After concluding a swap operation between a US\$ 1 billion bond and a new dual-tranche bond issue in May 2011, and following the issuance of a dual-tranche US\$ 1.2 billion Eurobond at end-July 2011 (the proceeds of which were partially used to refinance a US\$ 750 million bond that matured in August 2011), the Ministry of Finance completed in November 2011 a voluntary debt exchange offer. As such, 64.3% of total notes maturing in 2012 were exchanged.

In parallel, the local political tensions that prevailed during the first half of 2011 and the regional political unrest have had negative spillovers on the Beirut Stock Exchange in 2011 despite favorable fundamentals that highlighted the attractiveness of Lebanese stocks relative to regional peers. In fact, the BSE traded at a P/E ratio of 9.8x at end-December 2011 as compared to a P/E of 11.7x in the MENA region. In parallel, it reported a P/NAV ratio of 1.25x, versus 1.53x in the region.

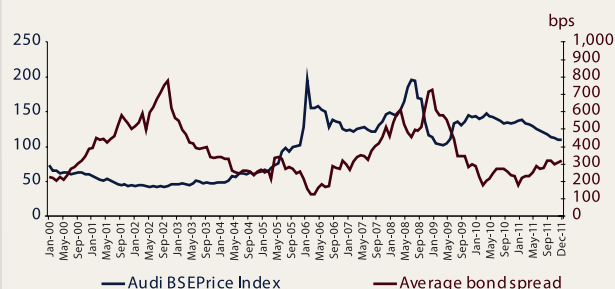
Despite attractive valuations, the BSE price index fell by 20.0% in 2011 (a 12.7% drop in Arab markets and a 21.1% fall in emerging markets) to close at 110.38 in a market lacking liquidity and efficiency. As to the volatility of prices, it is worth mentioning that the BSE volatility, measured by standard deviation of share prices to the mean of prices, recorded 6.9% in 2011, as compared to 9.7% in other emerging markets and 5.2% in other Arab markets. The turnover ratio, measured by the total trading value to market capitalization reached 5.2% in 2011, against 6.9% in 2010, which spots light on the lackluster mood that reigned over the market.

#### FINANCIAL SECTOR (NON BANKS)

	2007	2008	2009	2010	2011
<b>Beirut Stock Exchange</b>					
Market capitalization (in millions of US\$)	11,977	9,323	11,982	11,893	9,892
Total trading volume (in millions of US\$)	925	1,659	943	820	513
Annual trading volume/market capitalization	7.7%	17.8%	7.9%	6.9%	5.2%
Price index	149.1	115.8	144.0	137.7	110.4
% change in index	21.4%	-22.3%	27.3%	-4.4%	-19.8%
P/E ratio*	12.78	10.49	10.90	9.63	9.83
P/NAV ratio*	1.72	1.59	1.46	1.39	1.25
<b>Lebanese Eurobonds</b>					
Total volume (in millions of US\$)	16,965	17,178	17,704	17,736	18,954
Average yield	8.1%	8.7%	5.3%	4.1%	4.4%
Average spread (bps)	458	727	290	182	321
Average life (in number of years)	4.8	4.6	4.6	4.7	5.5

\* for listed banks

#### CAPITAL MARKETS PERFORMANCE





## 2. CONCLUSION: THE TWIN DEFICITS BACK TO THE FORE

Amid an atypical environment surrounding the country and the region, a number of questions come to the fore as to economic growth, inflation and banking and financial conditions in Lebanon. Those forecasts converge to the fact that the year 2012 is apt to be close to what the economy went through in the second half of 2011, i.e. in the aftermath of government formation and the renewal for Governor Riad Salameh, assuming no widespread drift in neighboring countries. On this basis, the Lebanese economy is apt to record a 3% to 4% growth, driven primarily by household consumption which is reporting resilience to the overall environment, while private investment is still subject to the overall wait and see attitude with the postponement of major investment decisions. As to inflation, it is expected to rise by an additional 2% relative to the past year as a result of wage adjustment in the private and public sectors to reach circa 8% over the year.

In parallel, banking conditions over the year ahead could be close to the ones prevailing over the past year, i.e. a moderate activity growth but sufficient to meet all the financing needs of the private and public sectors while attaining a high level of liquidity in an uncertain domestic and regional environment. More importantly, asset quality is likely to remain favorable with good financial standing, keeping in mind that banks' asset quality is a growing concern for global banks amid the continuing economic sluggishness. As to monetary conditions, they are apt to maintain their persisting stability, with the BDL foreign assets reaching a record high of US\$ 32.2 billion, the equivalent of 83% of LP Money supply, knowing that conversions from LP to foreign currencies were subject to a ceiling of 30% of LP money supply in the peaks of previous domestic tensions.

The expectations for ongoing stability should not occult the wide challenges within the context of a number of growing imbalances and that require the consolidation of efforts in the aim of facing them at the horizon. The main economic challenge is that tied to public finance conditions within the context of the expected rise in government spending and that might reverse the improvement in debt ratios, especially if it is not accompanied by a similar improvement in resource mobilization. Notwithstanding the emerging challenge tied to the deteriorating external balance after the balance of payments reported its first deficit in 10 years amidst rising import prices, stagnation in imports and contracting inflows.

Regarding the first challenge, the preparation of Lebanon's 2012 budget comes within a global atypical environment where public debt and deficit woes rise on the top of the radar screens of global investors, which makes the issue of avoiding public finance drifts among the top priorities, knowing that Lebanon's indebtedness ratio remains in the top decile of countries around the world. The inevitable default of Greece and the growing risks surrounding a number of advanced countries should represent lessons for countries that suffer from significant fiscal imbalances, of which Lebanon, so as to adopt prudential policies apt to avoid falling into a vicious circle of enduring economic and market drifts. It is worth mentioning that the delay in launching reforms in troubled European countries was coupled with a growing cost of debt servicing in those countries due to the growing market concerns in a way that offsets the net impact of promised adjustment measures.

As to the second challenge and that emerged specifically last year, it is tied to the need to hinder the deterioration in Lebanon's external balance. In the aftermath of a 16% expansion in Lebanon's foreign trade deficit last year, the foreign constraint comes back to the fore in Lebanon. It is thus essential to adopt measures that would promote import substitution goods and export oriented products in an attempt to reduce Lebanon's trade deficit that amounts today to circa 40% of GDP. It is important within this context to improve and expand the scope of the existing export support programs and to introduce new incentive programs and promotional campaigns targeting Lebanon's high value added sectors with low investment to value added ratios.

Amidst such growing deficits, significant efforts are needed on behalf of both government and private sector authorities to ensure all needed concessions and sacrifices are made in the aim of restoring equilibrium in public finances on one hand and in Lebanon's foreign accounts on the other hand. Avoiding wide uncontrollable drifts actually requires a thorough awareness among Lebanese themselves in the aim of sustaining Lebanon's economic stability amidst tough local, regional and global conditions at large.