

TABLE OF CONTENTS

| | |
|---------------------|----|
| Executive Summary | 1 |
| Introduction | 2 |
| Economic Conditions | 3 |
| Real Sector | 3 |
| External Sector | 6 |
| Public Sector | 7 |
| Financial Sector | 8 |
| Concluding Remarks | 11 |

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LEBANON ECONOMIC REPORT

AN "EQUILIBRIUM" WITHIN AN OVERALL "DISEQUILIBRIUM"

- **Real economy characterized by consumption resilience coupled with investment sluggishness**
The Lebanese economy, which started the year with a net improvement in real sector indicators, has lost some steam in the second quarter which witnessed some security drifts and threats. According to a survey by Bloomberg, the Lebanese economy is now expected to grow by 1.7% in 2016, down from the forecast of 2.2% undertaken at end-March. Having said that, while there is a continuing wait-and-see attitude among investors delaying major investment decisions, there were some partially mitigating factors such as the positive growth of private consumption on behalf of Lebanese citizens and Syrian refugees. The 7% growth in the government's VAT receipts and the 7% rise in imports year-on-year lie within this direction.
- **Widening balance of payments deficit amid growing trade deficit**
Lebanon's trade deficit reported an increase of 10.7% in the first half of 2016 due to declining exports and growing imports. Imports grew by 6.9% while exports declined by 11.1%. In parallel, financial inflows rose by 5.5%, moving from US\$ 5.9 billion in the first half of 2015 to US\$ 6.2 billion in the first half of 2016. With inflows failing to offset the widening trade deficit, the balance of payments reported a noticeable deficit of US\$ 1.8 billion in the first six months of 2016, against a deficit of US\$ 1.3 billion in the corresponding 2015 period.
- **A noticeable growth in fiscal deficit**
The first quarter of the year witnessed a deterioration in Lebanon's public finances as suggested by recent figures released by Lebanon's Ministry of Finance. In fact, Lebanon's public finance deficit rose by 35.7% over the first three months of 2016 relative to last year's corresponding period to reach US\$ 1.4 billion. This is the result of a significant rise of 23.1% of public finance expenditures in conjunction with a lower growth in public finance revenues of 16.7%. The country's gross debt reached US\$ 71.5 billion at end-May 2016, up by 1.7% from the level seen at end-2015, and up by 3.0% from the level registered at end-May 2015.
- **Sustained high level of FC reserves despite uncertainties**
The first half of the year 2016 was marked by a sustained high level of foreign currency reserves, contracted growth in LP money supply on the back of some LP-to-FC conversions, and an extended expansion in LP CDs portfolio. The Central Bank of Lebanon's foreign assets managed to maintain a high level of US\$ 36.3 billion at end-June 2016 despite local uncertainties and some conversions in favor of foreign currencies, though slightly dropping by US\$ 815 million since year-end 2015. BDL's foreign assets covered 68.1% of LP money supply at end-June 2016 as compared to 71.1% at end-2015.
- **Bank deposit growth slowdown coupled with higher lending**
Customer deposits, a major banking activity driver, witnessed a slowdown relative to the first half of 2015. They rose by 2.0%, or US\$ 3.1 billion, since the start of this year. This compares to a higher US\$ 4.2 billion between December 2014 and June 2015. Lending activity grew by 3.1% or US\$ 1.7 billion, twice the growth in volumes of the low base realized during the 2015 similar period.
- **Extended equity price declines, further expansion in bond and CDS spreads**
Lebanon's capital markets were not at the image of the slight improvement in the domestic economy during the first half of the year 2016, as reflected by extended equity price drops and expansions in bond and CDS spreads amid domestic and regional uncertainties. Despite attractive pricing ratios, the Beirut Stock Exchange extended its downward trajectory during the first half of the year 2016, as reflected by a 1.5% fall in the price index. In parallel, the Eurobond market attracted a decent bid during the first half of 2016, with both locals and internationals net buyers of Lebanese debt papers.

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The Lebanese economy, which started the year with a net improvement in real sector indicators, has lost some steam in the second quarter which witnessed some security drifts and threats. According to a survey by Bloomberg, the Lebanese economy is now expected to grow by 1.7% in 2016, down from the forecast of 2.2% undertaken at end-March. Having said that, while there is a continuing wait-and-see attitude among investors delaying major investment decisions, there were some partially mitigating factors such as the positive growth of private consumption on behalf of Lebanese citizens and Syrian refugees. The 7% growth in the government's VAT receipts and the 7% rise in imports year-on-year lie within this direction.

Most real sector indicators remain somehow on the upside, bearing in mind that they reported a slowdown in their growth in the second quarter of this year relative to their growth in the first quarter. Among indicators that witnessed increases over the first half-year, we mention cement deliveries with 14.5%, value of property sales with 11.7%, merchandise at the Port with 12.9%, construction permits with 7.5%, the number of tourists with 7.7% and the number of passengers at the Airport with 5.2%. Among indicators that witnessed decreases, we mention cleared checks that dropped by 2.7% and the velocity of money that contracted by 6.9%. Still, the 5.7% growth in the average coincident indicator in the first five months confirms a relative improvement in activity from the low base of last year.

At the external sector level, the first half of this year reported a significant widening in the balance of payments deficit amid a growing trade deficit. As a matter of fact, Lebanon's trade deficit reported an increase of 10.7% due to declining exports by 11.1% and growing imports by 6.9%. In parallel, financial inflows grew by 5.5% to reach US\$ 6.2 billion in the first six months of 2016. With inflows failing to offset the widening trade deficit, the balance of payments reported a noticeable deficit of US\$ 1.8 billion in the first half of 2016, against a deficit of US\$ 1.3 billion in the corresponding 2015 period.

At the fiscal level, this year witnessed a further deterioration in Lebanon's public finances as suggested by the 35.7% rise in public finance deficit over the first three months of 2016. This is the result of a significant 23.1% of public finance expenditures in conjunction with a lower growth in public finance revenues of 16.7%. The increase in fiscal deficit was accompanied by a 2.3% increase in total gross debt over the first quarter of 2016. Total public debt rose from US\$ 70.3 billion at end-December 2015 to US\$ 71.5 billion at end-May 2016. The growth was due to a 7.1% growth in foreign debt to US\$ 29.0 billion while domestic debt declined by 1.8% to US\$ 42.5 billion at the end of May.

At the monetary level, monetary conditions reported sustained resilience in the first half of 2016 despite the series of domestic and foreign tensions, with strong Central Bank international reserves reporting US\$ 36.3 billion at June-end 2016, though slightly dropping relative to their beginning-of-year level (US\$ 37.1 billion). Reserves were recently backed by swapping LP Tbs held by the Central Bank against government Eurobonds issued by the Treasury with a subsequent resale of these Eurobonds to Lebanese banks. Monetary resilience comes within the context of a quasi absence of price pressures. According to the Consultation & Research Institute's index of consumer prices, inflation has been at a 12-month moving average of a mere 0.7% within the context of domestic sluggishness and low oil prices.

At the banking sector level, banking activity saw a retreat in its growth pace this year. The 2016 first half deposit growth stands at US\$ 3.1 billion, below the deposit growth of US\$ 4.2 billion of the first half of 2015. As foreign currency deposits accounted for 64% of the deposit growth in the first half of 2016, deposit dollarization maintained in June 2016 its 64.9% level reported in December 2015. Paradoxically, loans to the private sector have been growing at a higher pace than that of last year, as they grew by US\$ 1.7 billion in the first six months of 2016 while they had grown by a mere US\$ 0.8 billion in the same period of 2015. The loan expansion supported banking sector profitability that rose by 6.2% over the first half of 2016 on the back of slightly rising spreads.

At the capital markets level, equity and bond markets failed to track the slight improvement in the domestic economic environment. Prices at the Beirut Stock Exchange declined by 1.5% over the first six months of 2016, while trading activity rose from US\$ 221 million in the first half of 2015 to US\$ 368 million in the first half of 2016. Still, the annual turnover ratio remains low at 7.1%, among the lowest in the region and in emerging markets at large. In parallel, Lebanon's 5-year CDS spreads widened by 42 basis points over the first half-year to reach 464 basis points at end-June 2016, reflecting a relative deterioration in market perception of sovereign risks at large.

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture and Industry

Lebanon's primary and secondary sectors sustain sluggishness

Lebanon's agricultural and industrial sectors sustained weakness during the first six months of 2016, as primary and secondary activity in the country was restrained due to the domestic political uncertainty and the spillover from Syria's civil war.

To begin with, the agricultural sector remained depressingly affected by the closure of the Jordan-Syria border crossing. The latter contributed to a contraction in agricultural exports by 4.5% in the first six months of 2016. Similarly, agricultural imports fell by 7.4% during the first six months of 2016.

The government recently took some steps to support local agriculturalists, but this proved insufficient to lift local farmers from their difficult positions. In fact, the Lebanese government announced a ban on imports of Syrian agricultural produce. This was well received by agriculturalists, but merchants doubted the feasibility of implementing such a decision in light of the continuous smuggling of illegal products at the border with Syria.

Just like the agricultural sector, the industrial sector's exports were negatively impacted by the high transportation costs due to the war in Syria. Industrial exports witnessed a contraction of 11.5% during the first half of 2016. Internally, industrial imports expanded by 8.7% year-on-year in the first half of 2016 from a low base last year.

It is important to note that the Ministry of Industry launched a vision for the year 2025 to encourage the creation of new industrial subsectors and raise productivity. The strategy intends to lift exports up to US\$ 5 billion and decrease imports from US\$ 18 billion to US\$ 16 billion, thus reducing the trade deficit from US\$ 15 billion to US\$ 11 billion. The vision also aims to raise the industrial sector's capacity in order to provide 50% to 70% of local consumption needs, enhance competitiveness, increase investments, and encourage new and green industries.

Moreover, Lebanon's bank financing for small and medium-sized enterprises through Kafalat loans saw a notable improvement in the first five months of 2016, with the value of total loans rising by 25% year-on-year to reach US\$ 40.4 million. As a matter of fact, financing to the agricultural sector expanded by 35.0% year-on-year in the first five months of 2016, and financing to the industrial sector also rose by 1.2%.

The total number of Kafalat loans rose by 30.0% from the previous period to reach 289 Kafalat loans in the first five months of 2016. Out of total extended Kafalat loans, the agricultural sector comprised the lion's share at 46.7%, followed by the industrial sector at 29.1%, and the tourism sector at 18.3%.

Last but not least, it is important to acknowledge the efforts taken by the Lebanese authorities to tackle the issues facing the industrial and agricultural sectors. Some of the challenges faced, such as the civil war in Syria, are systemic and cannot be easily addressed. Nonetheless, the initiatives taken by the government would help protect both industries from foreign competition and increase investor confidence in domestic products.

1.1.2. Construction

Improving performance on the supply and demand sides of the sector

The property market ended the first half of 2016 with a positive performance compared to the same period a year earlier after a relative correction in volumes. The market currently picked up after a decline in most of its indicators in the aforementioned period of last year.

In details, demand was on a rising path. Sales operations rose from 28,722 in the first half of 2015 to 29,988 in the corresponding period of 2016, an increase of 4.4% year-on-year. This follows a yearly decrease of 15.6% in the same period of last year. Furthermore, the number of property transactions registered an increase of 4.3% from 78,942 in the first six months of 2015 to 82,328 in the same period of this year. This comes after a decline of 5.6% year-on-year in the aforementioned period of 2015. However, foreign demand opposed the trend with sales to foreigners registering 491 operations, a yearly decline of 26.6%, as per the statistics published by the Directorate of Land Registry and Cadastre.

The value of property sales rose by a yearly 11.7% to stand at US\$ 4,009 million in the first half of 2016, compared to a decline of 20.0% registered in last year's same period. Most of the areas registered increases with the South, Beirut and Baabda reporting the highest increases (45.7%, 22.5% and 22.0% respectively).

In this context, Beirut ranked first in the value of property sales in the first six months of 2016, with US\$ 1,629.4 million (27.0% of the total), while Baabda came in second with US\$ 1,438.2 million (23.8% of the total) and Metn was third with US\$ 1,043.2 million (17.3% of the total).

On a side note, property taxes rose from US\$ 200.1 million in the first half of 2015 to US\$ 208.5 million in the same period of 2016, an increase of 4.2% year-on-year.

On the supply side, the construction sector witnessed an acceleration in its levels of activity. The latest statistics from the Central Bank of Lebanon revealed that cement deliveries, a coincident indicator of current construction activity, went up by a yearly 14.5% to reach 2,062,022 tons in the first five months of 2016, up from 1,800,689 tons in the same period of 2015.

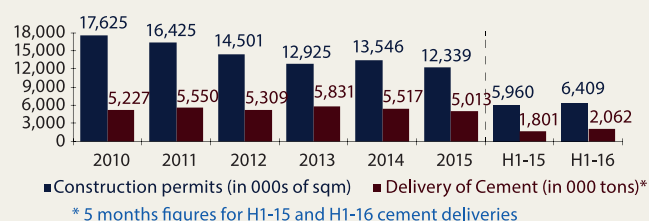
Similarly, figures released by the Order of Engineers of Beirut and Tripoli reveal that construction permits, an indicator of forthcoming construction activity, posted a 7.5% year-on-year increase during the first six months of 2016. In fact, construction permits covered an area of 6,409,388 square meters in the first half of 2016, against an area of 5,960,068 square meters in the corresponding period of 2015. The breakdown by region shows that Beirut only reported a contraction of 23.4% in construction permits in the aforementioned period of this year. All other regions reported increases with the highest of 33.1% seen in South-Lebanon, followed by 24.6% in Nabattiyeh and 22.5% in Bekaa. On the other hand, Mount-Lebanon continued to capture the highest share in newly issued construction permits in the first six months of 2016 with a share of 44.3%. This is in line with the demand for property in Mount-Lebanon by Lebanese residents, as prices in that area are more affordable than prices in the capital. It was followed by the North with a share of 17.8%, South-Lebanon with 14.5%, Nabattiyeh with 10.1%, Bekaa with 9.6%, and finally Beirut with 3.7%.

With demand and supply on an upward path, prices do not seem to follow a consistent trend. They reveal insignificant increases or decreases in some areas while remaining stagnant in others. In this context, looking at Beirut, the average price of apartments under construction on the first floor fell in more than half of the capital's neighborhoods (52%), according to Ramco. Prices rose in 41% of districts and remained stable in 6% of cases.

CONSTRUCTION

| | 2015 | | | 2016 | | | Var. | |
|--|--------|--------|--------|--------|--------|--------|--------|--------|
| | Q1 | Q2 | H1 | Q1 | Q2 | H1 | Q2/Q2 | H1/H1 |
| Value of property sales (in millions of US\$) | 1,623 | 1,964 | 3,588 | 2,048 | 1,961 | 4,009 | -0.2% | 11.7% |
| Number of property sales | 12,948 | 15,774 | 28,722 | 14,985 | 15,003 | 29,988 | -4.9% | 4.4% |
| o.w. Sales to foreigners | 307 | 362 | 669 | 254 | 237 | 491 | -34.5% | -26.6% |
| Average value per property sale (in US\$ 000) | 125 | 125 | 125 | 137 | 131 | 134 | 5.0% | 7.0% |
| Property taxes (in millions of US\$) | 93 | 107 | 200 | 109 | 99 | 209 | -7.3% | 4.2% |

EVOLUTION OF CONSTRUCTION INDICATORS



In conclusion, demand continues to grow stemming from the need of locals for housing, among others. In a forward look, limited supply of land in Lebanon, and relatively low leverage on behalf of developers, all serve a "sticky-on-the-downside" nature of market prices in the current socio-economic situation.

1.1.3. Trade and Services

Mixed performance in the activity of the tertiary sector

Lebanon's trade and services sector witnessed a mixed performance since the beginning of 2016. While the airport's activity had registered overall accelerating numbers along with a growth in maritime trade indicators, proxies of aggregate demand signaled a slowdown in spending behavior on the local front. Furthermore, tourism indicators had variable trends, with the number of tourists adopting an upward trail, while the performance of four and five stars hotels within the capital city and claimed VAT on tourists purchases registering negative growth.

At a first glance on Lebanon's maritime activity, the latest statistics released by the Port of Beirut show an overall growth in most of its indicators. Indeed, the Port's revenues increased by a yearly 1.9% in the first half of 2016. These reached US\$ 119.9 million in the first six months of 2016, up from US\$ 117.6 million in the same period of 2015. Furthermore, the number of containers recorded an annual increase of 10.8% to attain a total of 417,853 in the first half of 2016. The quantity of goods increased by a yearly 12.9% to 4,432 thousand tons in the first six months of 2016, following a decrease of 7.7% reported in the corresponding period of 2015. The number of ships posted an increase of 23.5% year-on-year to reach a total of 1,052 vessels in the first half of 2016. In contrast, transshipments declined by 11.0% year-on-year to attain 160,491 containers in the corresponding period of 2016.

The picture was also favorable at the level of the Airport. The number of passengers at the Airport was up by 5.2% year-on-year during the first half of 2016 with that of the arriving ones outpacing that of the departing ones. The former was up by 7.3% in the first half and the latter rose by 3.1% year-on-year.

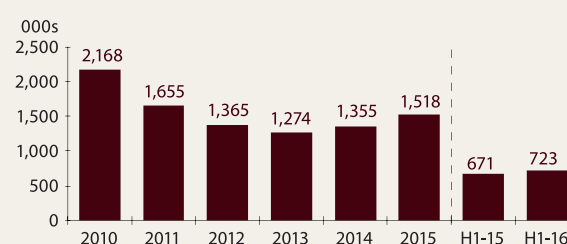
This goes along with the increase in the number of tourists by a yearly 7.7% to 723,105 in the first half of this year. It actually follows an increase of 14.7% witnessed in the same period of 2015. In details, European tourists took over the highest share of tourists in Lebanon, with a share of 33.0% of the total number of tourists in the first six months of 2016. They actually rose by 10.2% relative to last year's corresponding period. Tourists from Arab countries came in second with a share of 30.2% of the total number of tourists, with their number rising by 0.5% year-on-year. Then come tourists from Americas with 17.9% of the total number of tourists, followed by tourists from Asia that represent 8.3% of the total number of tourists. As to tourists from Africa and Oceania, they represent 6.7% and 3.8% respectively of the total number of tourists.

However, improving activity in the number of tourists was not reflected by the hotel sector. The average occupancy rate in four and five star hotels within the capital fell to 54% in the first half of 2016, relative to 57% in the equivalent period of 2015. This comes along with a decline in the average room rate from US\$ 164 in the first half of 2015 to US\$ 135 in the corresponding period of 2016, leading to a 21.7% decrease in the revenue per available room (REVPAR) over the same period, as per Ernst & Young. Consistently, according to Global Blue Lebanon, purchases by tourists in Lebanon whose VAT was claimed and which gives a fair value about tourists' shopping trends decreased by 14.0% in the first half of 2016.

TRADE AND SERVICES

| | 2015 | | | 2016 | | | Var. | |
|--|--------|--------|--------|--------|--------|--------|-------|-------|
| | Q1 | Q2 | H1 | Q1 | Q2 | H1 | Q2/Q2 | H1/H1 |
| Number of ships at the Port | 425 | 427 | 852 | 510 | 542 | 1,052 | 26.9% | 23.5% |
| Number of containers at the Port (in 000s) | 164 | 213 | 377 | 193 | 224 | 418 | 5.3% | 10.8% |
| Merchandise at the Port (in 000 tons) | 1,811 | 2,113 | 3,924 | 2,174 | 2,258 | 4,432 | 6.9% | 12.9% |
| Planes at the Airport | 14,469 | 16,365 | 30,834 | 16,056 | 16,676 | 32,732 | 1.9% | 6.2% |
| Number of passengers at the Airport (excluding transit, in 000s) | 1,371 | 1,734 | 3,106 | 1,518 | 1,748 | 3,266 | 0.8% | 5.2% |
| Cleared checks (in millions of US\$) | 16,952 | 17,787 | 34,739 | 16,886 | 16,915 | 33,801 | -4.9% | -2.7% |

EVOLUTION OF THE NUMBER OF TOURISTS



1.2. EXTERNAL SECTOR

A growing trade deficit amid lower exports and higher imports

The first half of this year reported a widening in the balance of payments deficit amid a growing trade deficit. As a matter of fact, Lebanon's trade deficit reported an increase of 10.7% due to declining exports and growing imports. Imports grew by 6.9% to move from US\$ 8.8 billion in the first half of 2015 to US\$ 9.4 billion in the first half of 2016. Exports declined by 11.1% to move from US\$ 1.6 billion in the first half of 2015 to US\$ 1.4 billion in the first half of 2016. Land exports through Syria reported a decline of 63.5% between the two periods along with a decline in exports through the Beirut Port by 4.6%, while exports through the Airport increased by 7.2%.

In parallel, financial inflows rose by 5.5%, moving from US\$ 5.9 billion in the first half of 2015 to US\$ 6.2 billion in the first half of 2016. With inflows failing to offset the widening trade deficit, the balance of payments reported a noticeable deficit of US\$ 1.8 billion in the first six months of 2016, against a deficit of US\$ 1.3 billion in the corresponding 2015 period.

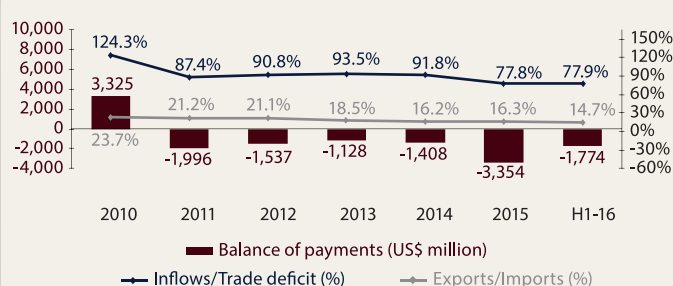
The breakdown of imports by product suggests that mineral products surged by 42.6% in the first half of 2016 relative to the 2015 corresponding period. It was followed by jewelry with an increase of 23.3%, miscellaneous products with a rise of 10.9%, cement and stone products with a growth of 9.4%, chemical products with an increase of 4.8%, and fats and oils with an uptick of 4.8%. In parallel, imports of livestock and animal products registered a decline of 10.4%, those of electrical products reported a contraction of 7.9% and those of vegetable products reported a drop of 7.0% over the period.

The breakdown of imports by major country of origin suggests an increase in imports from the Netherlands by a significant 354.1%, followed by those from the US with a rise of 32.2%, Greece with a surge of 25.7%, Italy with an increase of 14.1%, Saudi Arabia with a growth of 10.9%, Egypt with an increase of 8.8%, Spain with an increase of 8.5%, Japan with a rise of 7.3% and Turkey with an increase of 2.5%. In parallel, imports from Romania registered a contraction of 58.2%, while those from France registered a drop of 40.8%, those from Russia recorded a decline of 21.7%, those from Switzerland reported a decrease of 17.1% and those from United Kingdom registered a decline of 15.6%.

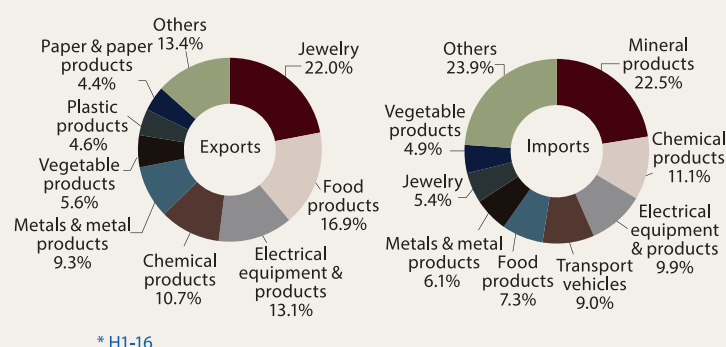
The breakdown of exports by product suggests that chemicals declined by 31.8% in the first half of 2016 relative to the 2015 corresponding period. It was followed by metals and metal products with a decline of 23.8%, textiles and textile products with a decrease of 23.6%, paper and paper products with a drop of 21.8%, electrical products with a decrease of 21.0%, miscellaneous products with a drop of 9.1% and food products with a contraction of 8.3%. In parallel, exports of jewelry increased by 28.3%, fats and oil reported a rise of 25.0% and those of plastic products registered an uptick of 1.6%.

The breakdown of exports by country of major destination suggests a decrease in exports to Egypt by 35.6%, followed by Turkey with a contraction of 31.9%, Saudi Arabia with a drop of 26.6%, Iraq with a contraction of 25.4%, UAE with a contraction of 22.4%, Syria with a decrease of 17.3% and Qatar with

FOREIGN SECTOR INDICATORS



BREAKDOWN OF EXPORTS AND IMPORTS BY COMMODITY*



a drop of 15.2%. In parallel, exports to South Africa registered an expansion of 107.5%, while those to Belgium recorded a rise of 30.0% and those to Germany reported an uptick of 6.1% in the first half of 2016.

1.3. PUBLIC SECTOR

A noticeable growth in fiscal deficit over the first quarter of the year

The first quarter of the year witnessed a deterioration in Lebanon's public finances as suggested by recent figures released by Lebanon's Ministry of Finance. In fact, Lebanon's public finance deficit rose by 35.7% over the first three months of 2016 relative to last year's corresponding period to reach US\$ 1.4 billion. This is the result of a significant rise of 23.1% of public finance expenditures in conjunction with a lower growth in public finance revenues of 16.7%. The former reported US\$ 3.9 billion while the latter reached US\$ 2.4 billion over the first three months of 2016.

The noticeable growth in public finance expenditures is tied to Treasury expenditures that rose by 122.4% while budget expenditures increased by 11.8%. Among Treasury expenditures, expenditures by municipalities reported five fold their figure of last year's corresponding period. In parallel, the growth in budget expenditures was realized despite the drop in Treasury transfers to EDL of 51.7% as a result of declining oil prices. It is worth mentioning that oil prices dropped by a yearly 31% in the first quarter of 2016. A 13.4% rise in local debt servicing was also reported between the two periods.

On the other hand, the growth in public finance revenues is tied to a 57.5% growth in Treasury revenues while budget revenues rose by 14.2%. The latter is due to a 32.0% growth in non-tax revenues, while tax revenues increased by 9.1%. The noticeable growth in non-tax revenues is mostly due to Telecom revenues that increased by 44.2%. The growth in tax revenues is tied to a 6.9% rise in VAT revenues, a 4.2% rise in customs revenues, while miscellaneous tax revenues increased by 12.7%. It is worth mentioning that the growth in VAT revenues is tied to a relative improvement in economic conditions, mainly private consumption, while the growth in customs revenues is due to an 11% rise in imports.

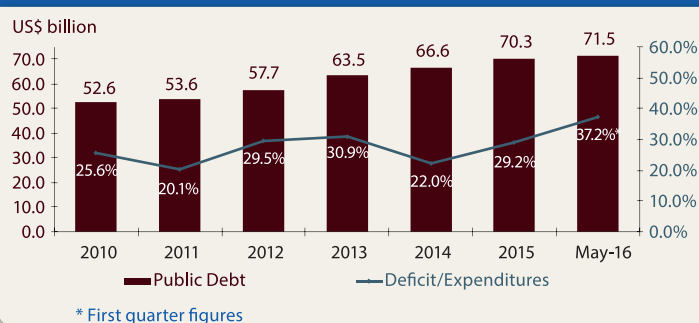
In parallel, the Ministry of Finance has increased the amount of public debt held in dollars by swapping local currency debt into US\$ 2 billion worth of Eurobonds. After the change, 59% of Lebanon's public debt would be held in Lebanese lira and 41% in US dollars. Before the change, the balance was 61% in lira and 39% in dollars. According to the Ministry, this process will help reduce the average cost of interest on the exchanged bonds from 7.53% to 6.59% on the new bonds and will lengthen the average maturity from 7.9 years for local currency bonds to 9.9 years for the Eurobonds.

Within this context, the country's gross debt reached US\$ 71.5 billion at end-May 2016, up by 1.7% from the level seen at end-2015, and up by 3.0% from the level registered at end-May 2015. Domestic debt was lower by 1.8% from end-2015 and higher by 0.8% from end-May 2015 to reach a total of US\$ 42.5 billion at end-May 2016. Lebanon's external debt grew by 7.1% from end-2015 and by 6.5% from end-May 2015 to stand at around US\$ 29.0 billion at end-May 2016. In this context, the public sector deposits at the Central Bank fell by 6.5% from end-2015 and by 27.6% from end-May 2015 to stand at US\$ 5.1 billion at end-May 2016. The public sector deposits at commercial banks edged up by 10.5% from end-2015 and by 19.3% from end-May 2015 to reach US\$ 3.7 billion at end-May 2016. As such, net public debt which excludes

PUBLIC SECTOR DEFICIT FINANCING

| in millions of US\$ | Q1-15 | Q1-16 | Progression |
|--|--------------|------------|---------------|
| Deficit financing | Vol | Vol | Vol |
| Deficit | 1,062 | 1,441 | 379 |
| State creditor accounts | 1,658 | -332 | -1,990 |
| Other items | 144 | -381 | -525 |
| Uses=sources | 2,864 | 728 | -2,136 |
| LP | 1,000 | 542 | -458 |
| Treasury bills (banking system) | 945 | 676 | -269 |
| Others | 56 | -134 | -190 |
| FX | 1,864 | 186 | -1,678 |
| Sovereign eurobonds (including Paris II bonds) | 1,837 | -30 | -1,867 |
| Others | 27 | 216 | 189 |

PUBLIC INDEBTEDNESS



the public sector deposits at the Central Bank and at commercial banks from overall debt figures, increased by 1.9% from end-2015 and by 5.8% from end-May 2015 to reach a total of US\$ 62.7 billion at end-May 2016. Net domestic debt amounted to US\$ 33.9 billion at end-May 2016, down by 2.2% from end-2015 and up by 5.2% from end-May 2015.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Sustained high level of FC reserves despite local uncertainties

The first half of the year 2016 was marked by a sustained high level of foreign currency reserves, contracted growth in LP money supply on the back of some LP-to-FC conversions, and an extended expansion in LP CDs portfolio.

In details, the foreign exchange market reported a sustained resilience during the first half of 2016 despite a two-year Presidential vacuum, adverse domestic security developments and heated local bickering over the implementation of a US Treasury law imposing sanctions on the Lebanese banking sector. The Central Bank of Lebanon's foreign assets managed to maintain a high level of US\$ 36.3 billion at end-June 2016 despite local uncertainties and some conversions in favor of foreign currencies, though slightly dropping by US\$ 815 million since year-end 2015. BDL's foreign assets covered 68.1% of LP money supply at end-June 2016 as compared to 71.1% at end-2015. When accounting for gold reserves estimated at US\$ 12.2 billion at end-June, this coverage ratio rises to 90.9%. Also, BDL's foreign assets covered 23.2 months of imports at end-June 2016. These sound coverage ratios continue to shed light on the Central Bank's strong ability to defend the currency peg and meet demand for foreign currencies in times of pressures.

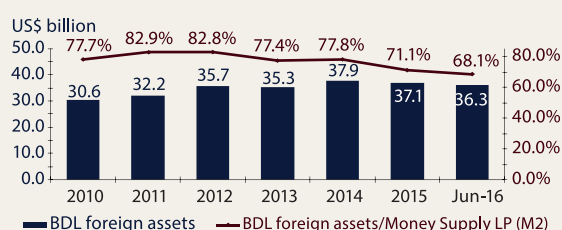
In parallel, the growth in LP Money Supply contracted year-on-year during the first half of 2016 given some LP-to-FC conversions, moving from LP 2,870 billion (the equivalent of US\$ 1,904 million) over the first half of 2015 to LP 1,652 billion (the equivalent of US\$ 1,096 million) during the same period of 2016. When adding foreign currency deposits, Money Supply in its broad sense (M3) grew by a shy 2.2% during the first half of 2016, the equivalent of US\$ 2,759 million, which is similar to the growth registered during the same period of 2015. This money supply growth compares to a money creation of US\$ 3,662 million during the first half of 2016 (US\$ 1,471 million during the corresponding period of 2015) that resulted mainly from a significant increase of US\$ 4,039 million in the State's indebtedness towards the banking system (excluding valuation adjustments) mainly due the swap between LP Tbs held by BDL and government Eurobonds issued by the Treasury with a subsequent resale of these Eurobonds to Lebanese banks, and a rise of US\$ 1,426 million in net bank lending to the private sector, within the context of a negative change in net foreign assets (excluding gold) of US\$ 1,803 million. The difference between the growth in money supply and money creation amounting to US\$ 903 million corresponds to a demonetization of monetary claims during the first half of 2016.

The aggregate financial system's subscriptions in Tbs (Banks + BDL) amounted to LP 11,966 billion over the first half of 2016, with the 10-year category capturing 29% of the total, followed by the 7-year category (16%), the one-year and five-year categories (13% each), the three-year category (11%), the two-year category (9%), the newly-issued 15-year category (4%), the three-month category (3%) and the six-month category (2%). The Central Bank of Lebanon continued to act as an intermediary between Lebanese banks and the sovereign,

MONETARY SITUATION

| Flows in US\$ million | H1-15 Vol | H1-16 Vol | Progression Vol |
|--|--------------|--------------|--------------------|
| Net foreign assets (excluding gold) | -1,536 | -1,803 | -267 |
| Net claims on the public sector (excluding valuation adjustments) | 2,026 | 4,039 | 2,013 |
| Claims on the private sector | 981 | 1,426 | 445 |
| Uses=Sources | 1,471 | 3,662 | 2,191 |
| Money (M3) | 2,761 | 2,759 | -2 |
| Valuation adjustment and other items | -1,290 | 903 | 2,193 |

EXCHANGE MARKET INDICATORS



as mirrored by a significant expansion of LP 8,878 billion in the BDL's LP securities portfolio over the first half of 2016 following a growth of LP 6,113 billion over the year 2015. The weighted average yield on LP Tbs portfolio reached 7.01% at end-May 2016, up from 6.98% at end-2015 following the issuance of the 15-year category at a yield of 7.90% for the first time in March 2016.

1.4.2. Banking Activity

Deposit growth slowdown yet coupled with higher lending

The banking sector activity almost maintained its mild rhythm of the previous couple of years, with total assets of banks operating in Lebanon rising by 2.3%, or US\$ 4.4 billion, to reach US\$ 190.4 billion at end-June amid slow economic growth in a tough domestic operating environment characterized by ongoing political tensions and fears of spillovers from the regional security conditions.

Traditionally a major activity driver, customer deposits witnessed a slowdown relative to the first half of 2015. They rose by 2.0%, or US\$ 3.1 billion, since the start of this year. This compares to a higher US\$ 4.2 billion between December 2014 and June 2015 and an average US\$ 4.6 billion growth over the first half year of the past five years. The slowdown in deposits is attributed to lower deposit growth on behalf of non-residents, who accounted for 10% of total deposit growth over the covered period (against 33% over the corresponding period of last year). The bulk of deposit growth is thus attributed to residents, with a slight advantage to foreign currency deposits (which accounted for 64% of total deposit growth).

Another driver of activity, lending to the private sector, yet somewhat picked up over the covered period, amidst the BDL's stimulus package aimed at giving a boost to lending to the slowly growing economy. Lending activity grew by 3.1% or US\$ 1.7 billion, twice the growth in volumes of the low base realized during the 2015 similar period. Lending activity in local currency accounted for nearly 40% of total growth in lending, the bulk of which was attributed to the resident sector.

The relative pick up in lending activity contributed to a slight rise in the loan-to-deposit ratio to 36.1%, though this level remains low by global standards and allows banks to further extend loans once conditions improve markedly. On top of such a large financial flexibility, Lebanese banks remain quite liquid with their primary liquidity at 47% of FC deposits, a level well above regional and global averages.

The continued lending activity growth in recent times has not come at the expense of the lending portfolio quality, with the NPLs/Total loans ratio remaining almost unchanged at a low 3.7% at end-June 2016, which is twice lower than the emerging markets and global averages. The stock of NPLs is well provisioned for, with the coverage ratio close to the 70% threshold. In parallel, capital adequacy is healthy, reaching 15.1% at end-2015 as per the latest BDL figures. Such an adequate capitalization ratio remains apt to shield Lebanese banks from potential pressures on their capital base.

Last but not least, the pick up in lending activity triggered a positive quantity effect that counterbalanced the still tight interest rate margins on the overall and the spillovers of slow economic growth on banks' fee

BANKING ACTIVITY

| in US\$ million | | | | 2015 | | | 2016 | | | Var. | |
|----------------------------|--------|--------|--------|-------|-------|-------|-------|-------|-------|--------|--------|
| | 2013 | 2014 | 2015 | Q1 | Q2 | H1 | Q1 | Q2 | H1 | Q2/Q2 | H1/H1 |
| Var: Total assets | 12,938 | 10,876 | 10,292 | 1,257 | 3,130 | 4,387 | 1,670 | 2,697 | 4,367 | -13.8% | -0.5% |
| % change in assets | 8.5% | 6.6% | 5.9% | 0.7% | 1.8% | 2.5% | 0.9% | 1.4% | 2.3% | -0.3% | -0.2% |
| Var: Total deposits | 11,207 | 8,220 | 7,160 | 1,036 | 3,119 | 4,155 | 857 | 2,214 | 3,071 | -29.0% | -26.1% |
| o.w. LP deposits | 2,149 | 3,397 | 3,721 | 1,024 | 1,340 | 2,364 | 396 | 700 | 1,096 | -47.8% | -53.6% |
| o.w. FC deposits | 9,058 | 4,823 | 3,440 | 12 | 1,779 | 1,791 | 461 | 1,514 | 1,975 | -14.9% | 10.3% |
| % change in total deposits | 9.0% | 6.0% | 5.0% | 0.7% | 2.1% | 2.9% | 0.6% | 1.5% | 2.0% | -0.7% | -0.9% |
| Var: Total credits | 3,929 | 3,518 | 3,326 | 245 | 598 | 843 | 830 | 828 | 1,658 | 38.5% | 96.7% |
| o.w. LP credits | 1,396 | 1,296 | 1,258 | 259 | 336 | 595 | 238 | 419 | 657 | 24.7% | 10.4% |
| o.w. FC credits | 2,533 | 2,221 | 2,069 | -13 | 262 | 249 | 591 | 410 | 1,001 | 56.5% | 302.0% |
| % change in total credits | 9.0% | 7.4% | 6.5% | 0.5% | 1.2% | 1.7% | 1.5% | 1.5% | 3.1% | 0.3% | 1.4% |

income generation and lead to a mild 6.2% increase in their bottom lines on a yearly basis in the first half of 2016. Return ratios nonetheless remain constrained relative to regional standards, with the annualized ROAA at 1.0% and the annualized ROAE at 11.2%.

1.4.3. Equity and Bond Markets

Extended equity price declines, further expansion in bond and CDS spreads

Lebanon's capital markets were not at the image of the slight improvement in the domestic economy during the first half of the year 2016, as reflected by extended equity price drops and significant expansions in bond and CDS spreads amid heightened domestic and regional uncertainties.

In details, despite attractive pricing ratios, the Beirut Stock Exchange extended its downward trajectory during the first half of the year 2016, as reflected by a 1.5% fall in the price index, from 104.64 at end-2015 to 103.04 at end-June 2016, following a 1.2% decrease in 2015, amid a two-year Presidential vacuum, heated local bickering over the implementation of a US Treasury law imposing sanctions on the Lebanese banking sector, and domestic security drifts and threats.

The BSE total trading value grew by 66.7% year-on-year during the first half of 2016 to reach US\$ 368 million, up from US\$ 221 million during the corresponding period of 2015. The decline in equity prices triggered a similar retreat in the BSE market capitalization of 1.5%, with the latter moving from US\$ 10,496 million at end-2015 to US\$ 10,335 million at end-June 2016. On the back of a high growth in value traded and a mere decline in market capitalization, the total turnover ratio, measured by the annualized trading value to market capitalization, reached 7.1% during the first half of 2016, up from 4.1% during the same period of 2015, yet still lagging far behind regional, emerging and global turnover ratios.

In parallel, the Eurobond market attracted a decent bid during the first half of 2016, with both locals and internationals net buyers of Lebanese debt papers. Domestic market players showed a healthy appetite for the new US\$ 1 billion bonds issued in April 2016, and the new US\$ 2 billion bonds issued in May 2016 following a swap between LP Treasury bills held by the Central Bank of Lebanon and government Eurobonds issued by the Treasury with a subsequent resale of these Eurobonds to Lebanese banks. The weighted average yield rose by 43 basis points during the first half of the year 2016 to reach 5.91% at end-June, mainly due to the inclusion of new high-yielding bonds totalling US\$ 3 billion in the Lebanese sovereign Eurobond portfolio.

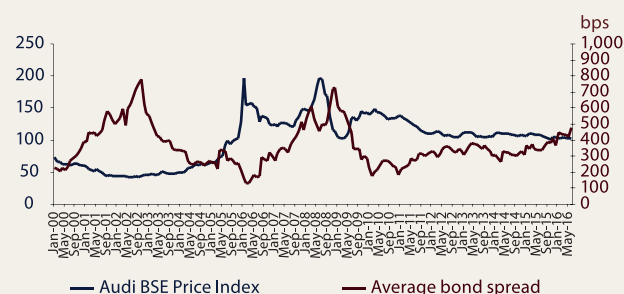
Having said that, the weighted average bond spread registered a large expansion of 112 basis points during the first half of the year to reach 480 basis points at end-June 2016, its highest level since end-May 2009, given rises in Lebanese yields and declines in US Treasuries yields. The 10-year US Treasury yield fell by 80 bps, moving from 2.27% at end-December 2015 to 1.47% at end-June 2016 after the US Federal Reserve left the target range for the federal funds rate unchanged and as the United Kingdom's decision

FINANCIAL SECTOR (NON-BANKS)

| | 2011 | 2012 | 2013 | 2014 | 2015 | Jun-16 |
|---|--------|--------|--------|--------|--------|--------|
| Beirut Stock Exchange | | | | | | |
| Market capitalization (in millions of US\$) | 9,892 | 9,982 | 10,057 | 10,550 | 10,496 | 10,335 |
| Total trading volume (in millions of US\$) | 513 | 408 | 345 | 619 | 498 | 368 |
| Annualized trading volume/Market cap | 5.2% | 4.1% | 3.4% | 5.9% | 4.7% | 7.1% |
| Price index | 110.4 | 108.6 | 105.3 | 105.9 | 104.6 | 103.0 |
| % change in index | -19.8% | -1.6% | -3.1% | 0.6% | -1.2% | -1.5% |
| P/E ratio* | 6.92 | 7.02 | 7.66 | 7.16 | 6.72 | 6.67 |
| P/NAV ratio* | 1.12 | 1.10 | 1.07 | 0.98 | 0.93 | 0.94 |
| Lebanese Eurobonds | | | | | | |
| Total volume (in millions of US\$) | 18,954 | 19,654 | 22,331 | 24,277 | 24,252 | 26,059 |
| Average yield | 4.4% | 4.4% | 5.1% | 4.5% | 5.5% | 5.9% |
| Average spread (bps) | 321 | 339 | 301 | 308 | 368 | 480 |
| Average life (in number of years) | 5.5 | 5.6 | 5.4 | 5.0 | 6.1 | 6.6 |

* For large listed banks

CAPITAL MARKETS PERFORMANCE



to leave the European Union spurred demand for safe haven assets. As to the cost of insuring debt, Lebanon's 5-year CDS spreads widened by 42 basis points to reach 464 basis points at end-June 2016, following a 26 basis points expansion in 2015, reflecting a relative deterioration in market perception of sovereign risks amid long-simmering Presidential deadlock, mounting local political tension, adverse domestic security developments, and lingering regional uncertainties.

2. CONCLUSION: MACRO/FISCAL PRESSURES ALONG WITH FINANCIAL/MONETARY RESILIENCE

There are no doubts that amid a grim regional turmoil and an intense local political bickering, the Lebanese economy is under considerable pressure in its goods markets, yet unmatched by similar pressures in the money market. The real macro pressures are actually translating into a sluggish real economy, in both its domestic and foreign components, along with deteriorating fiscal and external conditions.

Sluggish real economy: While this year might witness a slight improvement in real GDP growth relative to the low base of last year to reach 2% according to our forecast, the economy remains in a sluggish mode, with the real sector being impacted by the weakening of Lebanese corporates and institutions in the aftermath of lingering pressures for a number of years. Lebanon's cyclical output gap stands at above 20% of potential output, revealing largely underutilized capacities, with the past half a decade annual growth consistently way below its long term trend.

Weak investment environment: The regional turmoil has caused a net slowdown in investment in Lebanon, leading to weak gross capital formation rates that fell from 28% in 2010, prior to the Syrian turmoil, to 21% last year. There is a wait-and-see attitude among domestic and foreign investors, delaying major investment decisions. While public capital spending to GDP now stands at a mere 1%, one of the lowest ratios in emerging markets, real private domestic investment over the past five years has been 15% lower than in 2010. Foreign direct investment has contracted by 38% between 2010 and 2015, recently further exacerbated by the impact of the drop in oil prices on FDI emanating from oil exporting countries, which traditionally represented a strong share in Lebanon's FDI inflows.

Subdued exports: Foreign demand on Lebanese goods is adversely impacted by weaker economic activity in foreign trade partners, along with the insecurity of shipping routes in Syria. On the one hand, oil exporting countries, adversely affected by the collapse in oil prices, account for 44% of Lebanese exports. On the other hand, Lebanon's land exports through Syria, which used to account for a quarter of total exports, are now close to nil. As a result, total exports reported a cumulative decline of 31% over the past half a decade, after growing at a double-digit rate per annum over the previous decade (a CAGR of 20%). The ratio of exports to imports which used to be above 21% in 2010 dropped to below 15% in the first half of 2016.

Deteriorating fiscal conditions: Within the context of a weakened economic activity along with a drop in resource mobilization ratio from 22% to 18% over the past five years, government revenues took a hit while government spending has been on the rise, leading to an expansion in budget deficit/GDP from 7.6% in 2010 to above 10% of GDP this year, while debt to GDP continues to hover slightly below the 140% threshold, the third most elevated worldwide (just after Japan and Greece). While it is true that there are intrinsic considerations that help sustain high debt ratios such as the strong domestic component equivalent to 87% of total indebtedness and the persisting exit capacity in a country with low resource mobilization, with room for spending rationalization and with a considerable privatization potential, the fundamental economic sanity requires urgent fiscal consolidation to ensure the much needed soft-landing scenario of the Lebanese economy.

Having said that, despite the prevailing macro/fiscal pressures, the financial and monetary conditions continue to witness an atypical resilience, with a new resilience phase extending the long-term financial/monetary sustainability. Maybe the most fascinating about the Lebanese economic model is the noticeable sustainability over time despite the volatile operating environment on the one hand and the acute imbalances on the other hand. The country was actually able to maintain a long term sustainability trend in its inflation rates, its exchange rate, its capital inflows, and its banking activity.

The sustainability of low inflation: It was quite noticeable how Lebanon could sustain low one-digit inflation rates over a long period of time which extends for more than two decades, avoiding erratic price pressures. The Lebanese economy is actually operating on the flat Keynesian side of its aggregate supply curve allowing growth in aggregate demand to take place without significant price pressures. In particular, over the past 5 years, inflation has averaged 2.9% per annum, almost half the average of 5.6% for emerging markets. Bear in mind that a net deflation was reported last year amid the drastic decline in oil prices. Also bear in mind in this regard that the low inflation rates offset the recent appreciation of the Lebanese Pound (that paralleled the US dollar appreciation relative to the world currencies), thus leaving Lebanon's real effective exchange rate broadly unchanged.

The sustainability of the currency peg: In fact, Lebanon has remarkably sustained the stability of its pegged exchange regime, with no drift in the currency's exchange rate since 1993 despite some temporary monetary pressures at times of uncertainties. The sustainability of the peg was supported by macro and monetary dynamics, with the Lebanese Pound in line with the country's macroeconomic fundamentals. Maybe a tangible support for that is the average annual growth in M3 since 1993 (US\$ 5.1 billion) and that exceeds the average annual domestic money creation (US\$ 4.2 billion) in its two components of growth in bank claims on the private and public sectors. Currently, with BDL foreign assets including gold almost fully covering the stock of Lebanese pounds outstanding, the exchange sustainability is likely to continue prevailing at least in the near term. Even when excluding gold, foreign reserves currently account for 70% of Lebanese Pound Money Supply, more than double the average for similarly rated markets, suggesting a strong Central Bank capacity to maintain the currency peg.

The sustainability of financial inflows: Lebanon rises among the very few countries with sustained large capital inflows over a long period emanating mainly from a very large Diaspora of Lebanese non-residents equivalent to three times the Lebanese residents and keeping strong ties with the home economy. Lebanon's financial inflows to GDP averaged above 30% over the past half a decade of regional turmoil, supporting the country's financial equilibrium. Despite the downward correction in inflows since the collapse in oil prices, financial inflows still report more than US\$ 1 billion per month, the bulk accounted for by remittances. While it is true that the balance of payments turned into deficits since the year 2011, the cumulative deficit reported so far over the past half a decade (US\$ 9.4 billion) is less than the two-year surplus (US\$ 11.2 billion) reported in 2009 and 2010. As a matter of fact, over the past 25 years, Lebanon did not witness erratic fluctuations in the balance of payments, on the background of an average deficit of 5% of GDP and an average surplus of 9% of GDP.

The sustainability of banking activity: Last but not least, not far from the sustainability of financial inflows, the resilience of the banking industry in Lebanon over the past years has been intensively reported by almost all international reference institutions. What was particularly noticeable is the unique resilience of Lebanese banks that sustained activity during periods of domestic and external turmoil. Over the past two and a half decades, deposit growth reported an average CAGR of 15% per annum, with no single year-on-year decline in the deposit base. Supported by strict regulatory regime and well diversified conservative structures, such successful episodes of historical resilience are likely to further protect the banking industry in front of potential future shocks in a short to medium term horizon. In few words, Lebanon's banking sector represents the country's key inflow attractiveness and the cornerstone of its paradoxical resilience to turmoil amid volatile domestic and external conditions at large.

Lebanon's long track record of empirical sustainability in the financial and monetary markets rises as a noticeable appealing drive for Lebanon. More importantly, it looks like such a lengthy financial/monetary sustainability is apt to be extended over the forthcoming era in the absence of major domestic security drifts. This noticeable sustainability amid uncertainties henceforth lies at the heart of the Lebanese atypical conditions that have increasingly intrigued a large deal of keen observers in business and financial circles worldwide. It is finally this ongoing Lebanese paradox, and which could be fundamentally assimilated to an "equilibrium" within an overall "disequilibrium", that actually characterizes the intrinsic features of Lebanon's atypical model across time and space.