LEBANON ECONOMIC REPORT

ASSESSING THE POSSIBILITY OF A SOFTLANDING SCENARIO IN PUBLIC FINANCE CONDITIONS

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- Sluggishness in the economy's real sector

The Lebanese real sector economy has witnessed increasing pressure in the first quarter of 2019, without falling into recession or into net contraction in real terms. The real GDP growth outlook for 2019 stands at 1.3% as projected by the IMF, which though remaining positive, suggests weakened investment aggregate. Private consumption managed to continue growing over the first quarter of 2019, though at a relatively milder pace. The overall wait-and-see attitude characterizing private sector investors translated into somewhat refraining from investing in Lebanon's various economic sectors within the context of politico-economic uncertainties.

- Foreign trade deficit down by a yearly 14% in the first two months of the year

Lebanon's external sector witnessed a net decline in trade deficit by 14.4% in the first two months of 2019 compared to the 2018 corresponding period. This drop in trade deficit was the result of retreating imports by 11.8% and slightly increasing exports by 0.9% over the first two months of this year. The exports-to-imports ratio reached 19.4% over the period, up from 16.9% over the same period of 2018. It is yet worth mentioning that the balance of payments recorded a rising deficit of US$ 2 billion in the first three months of 2019, despite the drop in trade deficit, which is tied to contracting financial inflows.

- Increased demand for LP on FX market following cabinet formation

Lebanon's monetary conditions benefited from improved sentiment following the cabinet formation at end-January 2019 amid rising hopes that the new government would embark into the implementation of long-awaited economic and fiscal reforms. This has triggered an increased demand for local currency on the foreign exchange and brought the overnight rate back to its low single-digit level. The Central Bank of Lebanon's foreign assets moved from US$ 39.7 billion at end-December 2018 to US$ 38.6 billion at end-March 2019, down by US$ 1.1 billion. Accordingly, the BDL's foreign assets-to-LP money supply coverage ratio reached 76.5% at end-March 2019 against 77.8% at end-December 2018, yet remained well above the average of reserve adequacy in similarly rated countries (circa 42%), which highlights the Central Bank of Lebanon's continued ability to safeguard the peg.

- Renewed rise in deposits in March along with drop in LP interest rates

Lebanon's banking sector has benefited from an improved sentiment following the government formation with deposits renewing with growth especially during the month of March 2019. In parallel, LP interest rates have declined in the month of March, thus reflecting eased pressures, after an ascending trend in the past few months in the midst of domestic uncertainties, especially in the lengthy pre-government formation period marked by intensified local political bickering. In fact, while interest rates on LP deposits rose by 265 bps between February 2018 and February 2019, they declined by 41 bps during March 2019 to close the month at 8.75%. Rates on US dollar deposits, which had risen less than local currency ones in the past year, were mostly stable in March.

- Relative price stability across Lebanon's capital markets during the first quarter of 2019

Lebanon's fixed income market was marked by relative price stability during the first quarter of the year 2019, as the losses incurred at the beginning of 2019 were wiped out following the cabinet formation amid bets that the new government would embark into material economic and fiscal reforms. In parallel, Lebanese equities saw price retreats during the first quarter of the year amid reduced activity, in a market that suffers from a lack of liquidity and efficiency.

- Scenario of fiscal softlanding still plausible looking ahead

Looking forward, we believe there is still room for a softlanding scenario in public finance conditions rather than harmful measures with long lasting adverse effects such as devaluation or debt restructuring. There is still room to decrease the budget deficit and restrain debt growth through both revenue and spending measures that would hinge over increasing resource mobilization, improving tax collection, spending austerity, reforming the electricity sector, capturing CEDRE pledges, in addition to well managing the oil and gas resources.

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The Lebanese real sector economy has witnessed increasing pressure in the first quarter of 2019, without falling into recession or into net contraction in real terms. The real GDP growth outlook for 2019 stands at 1.3% as projected by the IMF, which though remaining positive, suggests weakened investment aggregate. Private consumption managed to continue growing over the first quarter of 2019, though at a relatively milder pace. The overall wait-and-see attitude characterizing private sector investors translated into somewhat refraining from investing in Lebanon's various economic sectors within the context of politico-economic uncertainties.

Out of 11 real sector indicators, 3 were up and 8 were down over the first quarter of 2019 relative to the previous year's corresponding period. Among indicators with positive growth, we mention the number of tourists with a rise of 3.7%, total exports with a growth of 0.9% and the number of passengers at the Airport with a slight increase of 0.4%. Among indicators with negative growth, we mention cement deliveries with a decrease of 31.3%, construction permits with a fall of 27.6%, new car sales with a decline of 22.5%, value of property sales with a contraction of 19.2%, merchandise at the Port with a fall of 14.3%, cleared checks with a decline of 11.9%, total imports with a contraction of 11.8% and electricity production with a decrease of 1.2% year-on-year. As a result of the above, the average coincident indicator of the Central Bank reported an annual contraction of 4.6% in the first two months of 2019, against a net expansion of 3.3% during the same period last year.

At the level of the foreign sector, exports rose by 0.9% while imports went down by 11.8% over the first 2 months of 2019, curbing down the trade deficit by 14.4%. But as inflows were not enough to offset the trade deficit, the balance of payments reported a rising deficit of US$ 2 billion in the first quarter. It is still worth mentioning within the same foreign context that the country is witnessing an improved touristic performance amid the Saudi ban lifting and the stable domestic security conditions, raising hotel occupancy, which moved from 54.9% in the first 2 months of 2018 to 65.0% in the first 2 months of 2019.

At the level of fiscal policy, the recent cabinet formation improved the country's near term outlook, with the launch of some of the awaited fiscal reforms related to the electricity sector and the 2019 budget, in addition to increased efforts for better governance. The challenges yet remain in the implementation, translating those overall plans into concrete actions and measures. At the monetary level, the monetary situation continues to be somewhat resilient amid sound BDL foreign assets of US$ 39 billion (77% of LP Money supply), and ample financial system's liquidity of circa 40% of FX customer deposits. In parallel, the average 12-month moving average CPI inflation stood at 3.7% in March.

At the banking level, after a gloomy month of January whereby Lebanon had witnessed a contraction in the deposit base, overall deposits increased again in February and March since Cabinet formation, yet bearing in mind that the increase in deposits falls short of the one needed to finance Lebanon's chronic deficits. As to interest rates, they declined on deposits in Lebanese pounds and stabilized on those in US dollars in March. It is worth mentioning that the average interest rate on LP deposits declined from 9.16% in February 2019 to 8.75% in March 2019, while the average interest rate on US dollar deposits reported 5.69% in March.

At the level of capital markets, the main reaction regarding Cabinet formation came from the markets themselves that welcomed the development. There has been a rise in demand for LP and a lower demand for USD on the FX market but not to the extent of BDL buying FX from Lebanese banks. The overnight rate, which was trading at double-digits (reaching 75% at times), is trading at its normal single-digit level of 5%. There has been some foreign demand on Lebanese Eurobonds, contracting their average yield to 9.28% lately, from a peak of 12% in mid-January, bearing in mind that it has reached a lower figure of 8.80% mid-Feb. The CDS spreads contracted to 800 bps versus more than above 900 bps mid-January, bearing in mind that it had reached 670 bps mid-Feb.

The detailed developments in the real sector, external sector, public sector and financial sector will be analyzed thereafter while the concluding remarks are left to assessing the likelihood of a softlanding scenario in public finance conditions.

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture and Industry

Primary and secondary sectors start year on rather mixed note

Lebanon's agricultural and industrial sectors started 2019 on a rather mixed note. The exports of the country's primary and secondary segments managed to grow especially after the long-overdue reopening of the Nassib border crossing between Jordan and Syria, while imports came slightly under pressure.

On the agricultural front, the sector's exports expanded during the first two months of the year, while imports slightly decreased. Agricultural exports increased by 11.4% during 2M 2019, against a rise of 6.1% in the same period of the previous year. Agricultural imports fell by 0.3% during 2M 2019, compared to a rise of 5.3% in the same period of 2018.

Moving on to the industrial sector, the performance was somewhat mixed, as imports weakened while exports slightly grew. As a matter of fact, imports of the industrial sector declined by 13.2% annually in the first two months of 2019 after falling by 8.4% in 2M 2018. Externally, industrial exports marginally rose by 0.2% from the previous year's level during 2M 2019, against a rise of 17.3% in the same period of 2018.

It is worth noting that those exports were somewhat supported by the opening of the Nassib crossing border between Syria and Jordan, after being closed for three years due to turmoil in Syria. The closure of the Nassib border crossing in 2015 cut off a vital access point to Jordan and Gulf markets.

Furthermore, figures released by the Kafalat Corporation indicate that loans extended to small and medium sized companies under the guarantee of Kafalat totaled US$ 2.3 million in the first two months of 2019, down by 76.7% year-on-year. Meanwhile, the aggregate number of guarantees amounted to 19 in the first two months of 2019, falling from 74 guarantees given in the corresponding period of last year.

Industry captured the largest share when it comes to the number of extended guarantees in the first two months of 2019, with 8 or 42.1% of the total number of guarantees. Tourism came in next with 5 guarantees (26.3%) over the same period. They were followed by agriculture with 4 guarantees (21.1%). Specialized technologies and handicrafts both had only 1 guarantee each (5.3%) in the first two months of 2019.

As for the distribution of guarantees by area, Mount Lebanon accounted for the biggest share of given guarantees with 10 guarantees (52.6%), followed by Bekaa with 3 guarantees (15.8%), the South and Beirut with 2 guarantees each (10.5%), while the North and Nabattiyeh had 1 guarantee each (5.3%).

Last but not least, going forward, the performances of Lebanon's primary and secondary sectors hinge on the economic policies of the Lebanese government. Possible reforms to be undertaken by the government alongside the reopening of some trade routes and Syria's foreseen reconstruction efforts can affect the growth of industrial and agricultural exports looking ahead.

1.1.2. Construction

Continued retreat in all of the construction sector's indicators

The Lebanese real estate sector remained under stress during the first quarter of this year, following a tough year. The sector which does not seem to show any signs of recovery especially with the persistent socio-economic situation and the delays in housing loans posted declines in both its demand and supply indicators over the covered period.

In details, the statistics published by the Directorate of Land Registry and Cadastre covering the first quarter of 2019 showed that realty markets extended last year's downturn and continued to undergo a decrease in property transactions and sales activity. The number of sales operations retreated by a yearly 14.9% from 14,181 sales operations in the first quarter of 2018 to 12,067 operations in the first quarter of 2019. Moreover, the number of transactions retreated from 41,521 in the first quarter of 2018 to 36,814 in the same period of this year, a yearly decline of 11.3%. Sales to foreigners contracted by 14.3% year-on-year to reach 234 operations in the first quarter of 2019.

The value of property sales transactions was also on a downward path in the first quarter of 2019. It posted a decline of 19.2% year-on-year to attain a total of US$ 1,625.1 million during the first quarter of 2019. Most of the regions recorded declines in the value of sales transactions, with the most significant movements coming as follows: Keserouan (-54.8%), Baabda (-30.9%) and Bekaa (-25.0%). On a similar path, the average sales value declined from US$ 141,845 in the first quarter of 2018 to US$ 134,676 in the first quarter of 2019. Furthermore, property taxes followed the declining trend, retreating by a yearly 27.6% from US$ 113.3 million in the first three months of 2018 to US$ 82.0 million in the corresponding period of 2019.

On the supply side, construction permits, an indicator of forthcoming construction activity, reported a 27.6% year-on-year contraction during the first three months of 2019, amidst the continued slowdown in the sector whereby some developers are slowing down or sometimes halting their construction works.

In fact, construction permits covered an area of 1,945,737 square meters in the first three months of 2019, against an area of 2,688,858 square meters in the same period of last year. This followed a yearly contraction of 14.5% registered in the first quarter of 2018. The breakdown by region shows that most of the regions reported contractions in construction permits with Nabattiyeh and Bekaa reporting the highest contractions of 42.1% and 41.0% respectively in the first three months of 2019.

As for the absolute breakdown of construction permits, Mount-Lebanon continued to capture the highest share in newly issued construction permits in the first three months of 2019 with a share of 38.1%. It was followed by North-Lebanon with 20.2%, South-Lebanon with a share of 18.3%, Beirut with 8.5%, Bekaa with 8.3% and Nabattiyeh with 6.7%.

Moreover, figures released by the Central Bank of Lebanon show that cement deliveries, a coincident indicator of construction activity, declined by a yearly 31.3% in the first two months of 2019. Cement deliveries actually reached circa 420,370 tons in the first two months of 2019, down from 612,290 tons in the corresponding period of 2018, reflecting the continued slowdown in the construction activity in the country.

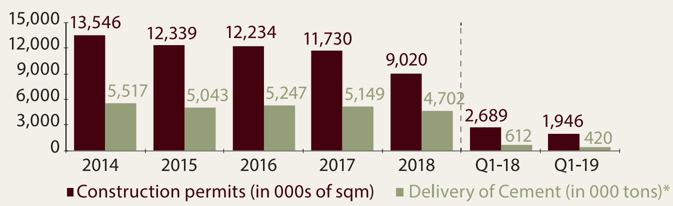
On a side note, it is worth mentioning that both the residential sector and the business real estate market in Beirut are in a slump. Fewer projects are under way in the office market. Low sales ratios and dropping sales prices dampen developers' appetite. Furthermore, the stock of unsold offices completed during the past few years is on the rise, which proves that the market starts to reach saturation point, as per RAMCO.

In conclusion, it is clear that the real estate market in all its branches is suffering from a continued downturn. The overall politico-economic uncertainties and the subsequent lower buyers' appetite amid higher interest rates is putting pressure on demand and forcing supply to follow the decreasing path as well.

CONSTRUCTION

	2017	2018	Q1-18	Q1-19	Variation Q1/Q1
Value of property sales (in millions of US$)	9,954	8,134	2,012	1,625	-19.2%
Number of property sales	73,541	60,714	14,181	12,067	-14.9%
o.w. Sales to foreigners	1,364	1,214	273	234	-14.3%
Average value per property sale (in US$ 000)	135	134	142	135	-5.1%
Property taxes (in millions of US$)	550	414	113	82	-27.6%

EVOLUTION OF CONSTRUCTION INDICATORS



* 2-month figures for Q1-18 & Q1-19 cement deliveries

1.1.3. Trade and Services

Lebanon's tertiary sector started the year on a mixed note

Lebanon's tertiary sector witnessed rather a mixed performance over the first quarter of 2019, performing well at the level of tourist activity and hospitality amid Saudi travel ban lifting and stable domestic security conditions, while coming under pressure at the level of maritime trade and domestic spending.

To begin with, the number of tourists registered 375,815 in the first quarter of 2019, compared to 362,392 tourists posted in 2018 corresponding period, up by 3.7%. In details, Arab countries and Europe got the lion's share in the contribution to the number of tourists with 36.4% (136,789 tourists) and 35.0% (131,505 tourists) respectively. It is worth mentioning that Arab tourists registered an increase of 16.4% over the first quarter of 2019, against a decline of 7.1% over the same period of 2018. These were followed by tourists from America which took over a share of 14.0% (52,773 tourists). Tourists from Asia came in after with a share of 8.2% (30,655 tourists), while those of Africa followed with a share of 3.0% (11,181 tourists).

In parallel, Global Blue Lebanon, the firm that reimburses VAT to tourists at Lebanese border points, has reported over the first quarter of 2019 that purchases by tourists in Lebanon whose VAT was claimed, which gives a fair view about tourists' shopping trends, has risen by 12.2% during the first quarter of 2019 compared to the same period a year earlier.

Subsequently, and according to Ernst & Young's "Middle East Hotel Benchmark Survey", the performance of Lebanon's hospitality sector witnessed an improvement in occupancy rates, alongside an improvement in average room rates and room yields. As a matter of fact, the occupancy rate of four and five star hotels within the capital reached 65.0% in the first two months of 2019, against 54.9% in the same period of 2018. The occupancy rate within Beirut was the eight highest among 14 cities included in the survey. Beirut's room rate notably moved up from the first two months of 2018 to attain US$ 192 in the first two months of 2019 from US$ 174 in the past year. The rooms' yield rose by 31.6% annually to reach US$ 125 over the same period compared to US$ 95 in the same period of 2018.

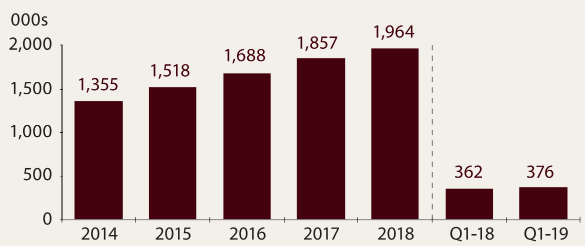
Improving activity on the tourism front was somewhat paralleled by rising Airport activity, as the figures released by the Rafic Hariri International Airport revealed that the total number of passengers (arrivals and departures) recorded a yearly 0.4% increase in the first three months of 2019, from 1,727,949 passengers to 1,734,617 passengers between the two periods. A detailed look at the activity shows that the number of incoming passengers fell by a yearly 0.2% and that of departing passengers increased by 0.9% to reach 838,759 and 895,858 respectively in the first quarter of 2019. The number of aircraft rose by 0.4% year-on-year in the aforementioned period, while the total freight handled by the airport edged down by 8.3% year-on-year in the aforementioned period.

Moving on to maritime trade, the Port of Beirut revealed a yearly 16.2% decline in the Port's revenues in the first quarter of 2019 compared to the same period of the previous year. The Port's revenues reached US$ 49.8 million in the first quarter of 2019. In parallel, the number of containers recorded an annual decrease of 12.4% to attain a total of 184,293 in the first quarter of 2019. The number of ships posted a fall of 12.7% year-on-year to reach a total of 411 vessels in the first quarter of 2019. During the corresponding period of 2018, the former had registered an increase of 5.3% year-on-year and the latter rose by 2.2%.

TRADE AND SERVICES

	2017	2018	Q1-18	Q1-19	Variation Q1/Q1
Number of ships at the Port	1,909	1,872	471	411	-12.7%
Number of containers at the Port (in 000s)	898	874	210	184	-12.4%
Merchandise at the Port (in 000 tons)	8,629	7,985	2,060	1,766	-14.3%
Planes at the Airport	71,171	73,626	15,345	15,413	0.4%
Number of passengers at the Airport (excluding transit, in 000s)	8,231	8,838	1,728	1,735	0.4%
Cleared checks (in millions of US$)	68,236	66,560	16,824	14,822	-11.9%

EVOLUTION OF THE NUMBER OF TOURISTS



The quantity of goods fell by a yearly 14.3% to 1,766 thousand tons in the first quarter of 2019, following a decline of 5.5% reported in the first quarter of 2018.

Finally, the total value of cleared checks, an indicator of consumption and investment spending in the Lebanese economy, declined by 11.9% year-on-year in the first quarter of 2019 pointing to a relative deceleration in spending during the aforementioned period. The value of cleared checks reached US$ 14,822 million in the first three months of 2019, against US$ 16,824 million in the same period of 2018. Furthermore, the number of cleared checks registered 2,651,962 in the first three months of 2019, down by 10.8% from 2,973,446 in the same period of 2018.

1.2. EXTERNAL SECTOR

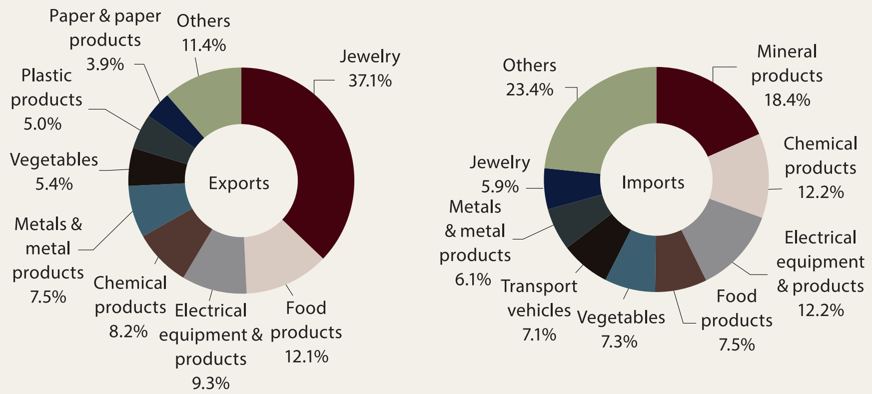
Foreign trade deficit down by a yearly 14% in the first two months of the year

Lebanon's external sector witnessed a net decline in trade deficit by 14.4% in the first two months of 2019 compared to 2018 corresponding period, moving from US$ 2.6 billion to US$ 2.2 billion, according to the latest trade statistics released by Lebanon's Customs Authority. This drop in trade deficit was the result of retreating imports by 11.8% and slightly increasing exports by 0.9% over the first two months of this year. Accordingly, the sum of exports and imports went down by 10.0% to reach US$ 3.3 billion over the period, while the exports-to-imports ratio reached 19.4% over the period, up from 16.9% over the same period of 2018. It is worth mentioning that the balance of payments recorded a rising deficit of US$ 2 billion in the first quarter of 2019, despite the drop in trade deficit, as it was impacted by weakening inflows over this period.

Going further into details, imports reached US$ 2.8 billion over the first two months of 2019, compared to US$ 3.1 billion over the same period of the previous year. The breakdown of imports by major product suggests that almost all products witnessed a decline over the period when compared to the same period in 2018. The main items to have displayed the most significant retreat were jewelry with 32.6%, followed by metals and metal products with 30.2%, cement and stone products with 29.6%, transport vehicles with 19.5% and textiles and textile products with 18.3% during the first two months of 2019 relative to the first two months of 2018. The breakdown of imports by country of origin in the first two months of the year shows that most of the inward merchandise came from China with 11.3% of total imports, followed by Greece with 7.4%, Italy with 7.3%, Germany with 5.6%, USA with 5.2%, Russia with 4.9%, Turkey with 4.1% and France with 3.9% of total imports over the period.

Total exports reached US$ 536 million in the first two months of 2019, from US$ 531 million in the first two months of 2018. It is worth mentioning that exports through the Port of Beirut witnessed a decline by 8.4% over the same period, while those through the Hariri international Airport went up by 13.0%, and Land exports through Syria went up significantly moving from US$ 26 million to US$ 53 million, supported by the gradual reopening of trade routes through conflict countries in the region.

BREAKDOWN OF EXPORTS AND IMPORTS BY COMMODITY*



* 2M-19

The analysis of exports by major products suggests that exports of papers and paper products reported a 16.7% increase over the same period, followed by vegetable products with 16.0%, jewelry with 13.7%, and electrical equipment with 13.6%. In parallel, exports of metals and metal products decreased the most among the major categories with a drop of 46.7%, followed by chemical products with 25.4%, and textiles and textile products with 14.3% over the first two months of 2019 relative to the same period of 2018. The geographic distribution of domestic exports indicates that 17.5% of total exports went to Switzerland, followed by UAE with 14.4% of the total, South Africa and Syria with 7.6% each, Saudi Arabia with 6.2%, Qatar with 4.7%, and Iraq with 3.4% of the total, with Arab countries taking over the lion's share with almost 50% of total exports over first two months of the year.

1.3. PUBLIC SECTOR

Growth in public spending outpacing that in public revenues

Following a net improvement in public finance performance in 2017, the first eleven months of 2018 witnessed a net reversal in Lebanon's public finances as suggested by the recent figures released by Lebanon's Ministry of Finance. This resulted from a significant rise of 21.4% in public expenditures (mainly tied to the public sector wage scale) in conjunction with a much lower growth in public revenues of 4.7% (mainly tied to the economic sluggishness amid low real sector activity growth). As such, and within the context of a 10.4% rise in debt service, the primary balance shifted from a surplus of US$ 1,442 million to a primary deficit of US$ 491 million over the first eleven months of 2018.

A detailed look at public finance statistics over the same period shows that public revenues went up from US$ 10.3 billion during the first eleven months of 2017 to US$ 10.7 billion during the 2018 corresponding period, while public expenditures reported a noticeable growth from US$ 13.6 billion to US$ 16.6 billion between the two periods. Accordingly, the public finance deficit expanded from a low base of US$ 3.4 billion during the first eleven months of 2017 to US$ 5.8 billion during the corresponding period of 2018, to reach 11.1% of GDP over the period, compared to 6.9% of GDP in 2017. It is worth mentioning that in the new policy statement of the Government, the Cabinet committed to a reduction in deficit to GDP by 1% per annum.

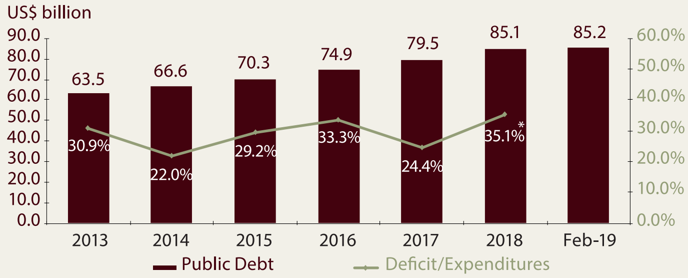
Having said that, the noticeable growth in public expenditures is tied to budget expenditures that rose by 21.7% and Treasury expenditures that increased by 17.7% over the 11-month period. The growth in budget expenditures was realized as a result of a 28.9% hike in general expenditures within the context of a 41.4% rise in Treasury transfers to EDL amid rising oil prices and a 10.4% rise in interest payments. In parallel, the rise in Treasury expenditures comes within the context of a hike in expenditures by municipalities of 47.9% over the first eleven months of 2018. On the other hand, the moderate growth in public revenues came within the context of a moderate rise in tax revenues by 3.2% along with an increase in non-tax revenues by 10.1% mostly due to Telecom revenues that went up by 29.0% over the period.

In parallel, the data published by the Ministry of Finance in Lebanon showed that the country's gross debt reached US$ 85.2 billion at end-February 2019, up by 4.6% from the level seen at end-February 2018, and almost unchanged from end-2018. Domestic debt was higher by 1.1% from end-February 2018 to reach a total of US$ 51.5 billion at end-February 2019. Lebanon's foreign debt grew by 10.3% from

PUBLIC SECTOR DEFICIT FINANCING

in millions of US$	11M-17	11M-18	Progression
Deficit financing	Vol	Vol	Vol
Deficit	3,376	5,809	2,433
State creditor accounts	125	-1,563	-1,688
Other items	977	-109	-1,086
Uses=sources	**4,478**	**4,137**	**-340**
LP	**2,147**	**1,152**	**-994**
Treasury bills (banking system)	1,828	590	-1,237
Others	319	562	243
FX	**2,331**	**2,985**	**654**
Sovereign eurobonds (including Paris II bonds)	2,168	3,197	1,029
Others	163	-212	-375

PUBLIC INDEBTEDNESS



* Full-year 2018 estimates extrapolated from 11-month actual figures

end-February 2018 to stand at around US$ 33.7 billion at end-February 2019. In this context, net public debt, which excludes the public sector deposits at the Central Bank and commercial banks from overall debt figures, increased by 9.1% from end-February 2018 to reach a total of US$ 76.5 billion at end-February 2019. Public debt to GDP is thus estimated at 150.3% as at end-February 2019, and is expected to reach 157.8% as at end-2019 as per the IMF.

By the finalization of this report, the cabinet was debating the budget law proposal submitted by the Ministry of Finance for the year 2019. The proposal revolves around a deficit to GDP ratio of 9%, down from above 11% deficit ratio actually realized in 2018. Among the main measures suggested by the Budget Proposal is reducing public sector allowances, putting a ceiling on public sector benefits so as not to exceed the basic salary, putting a ceiling on the number of months of salaries for public servants (13 months), making income taxes more progressive to reach a ceiling of 25% rather than 20% currently, raising the withholding tax on interest from 7% to 10% and canceling exemptions from custom duties except those subject to international agreements.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Increased demand for LP on FX market following cabinet formation

Lebanon's monetary conditions benefited from improved sentiment following the cabinet formation at end-January 2019 amid rising hopes that the new government would embark into the implementation of long-awaited economic and fiscal reforms. This has triggered an increased demand for local currency on the foreign exchange and brought the overnight rate back to its low single-digit level. Also, the first quarter of the year 2019 was marked by higher interest rates on LP-denominated securities, a mild decline in the Central Bank of Lebanon's foreign assets along with a shy expansion in LP Certificates of Deposits portfolio.

In details, the formation of a new government at end-January 2019 provided a relief to the foreign exchange market and triggered an increased demand for the local currency after months-long wave of net conversions in favor of foreign currencies, noting that some market players sought to benefit from attractive LP rates offered by commercial banks on LP saving products. At the mirror image of eased pressures on the FX market, the overnight rate fell from a double-digit level of 35% at end-December 2018 (noting that it reached a peak level of 75% during the month) to a low level of 4% at end-March 2019. Within this context, the Central Bank Governor said that the increased offer for US dollar on the foreign exchange market following the cabinet formation "strengthens the role of the Lebanese Pound as a vehicle for savings".

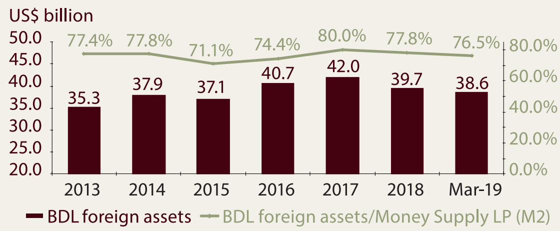
As to foreign currency buffers, the Central Bank of Lebanon's foreign assets moved from US$ 39.7 billion at end-December 2018 to US$ 38.6 billion at end-March 2019, down by US$ 1.1 billion. This followed a US$ 2.3 billion contraction over the year 2018. Accordingly, the BDL's foreign assets-to-LP money supply coverage ratio reached 76.5% at end-March 2019 against 77.8% at end-December 2018, yet remained well above the average of reserve adequacy in similarly rated countries (circa 42%), which highlights the Central Bank of Lebanon's continued ability to safeguard the peg.

The financial system's total subscriptions in LP Treasury bills amounted to LP 4,515 billion during the first quarter of 2019 against LP 7,771 billion during the same period of 2018, down by circa 42% year-on-year, as

MONETARY SITUATION

Flows in US$ million	Q1-18 Vol	Q1-19 Vol	Progression Vol
Net foreign assets (excluding gold)	-310	-2,002	-1,692
Net claims on the public sector (excluding valuation adjustments)	1,344	1,065	-279
Claims on the private sector	-1,533	-1,822	-289
Uses=Sources	**-499**	**-2,759**	**-2,260**
Money (M3)	1,122	-1,089	-2,211
Valuation adjustment and other items	-1,621	-1,670	-49

EXCHANGE MARKET INDICATORS



commercial banks placed long-term LP term deposits at BDL to benefit from LP facilities at 2%. In parallel, the Central Bank of Lebanon continued to play the role of an intermediary between banks and the sovereign during the first quarter of the year, as reflected by a LP 1,595 billion growth in its LP securities portfolio.

As to interest rates, after remaining stable for more than six years, Lebanon's Ministry of Finance lifted in January 2019 LP rates on the three-month, six-month, one-year, two-year, three-year, five-year and seven-year LP Tbs categories at a range of 0.86% to 1.92%. This followed a previous increase in LP interest rates on longer-term 10-year and 15-year categories in December 2018.

On the other hand, the total LP Certificates of Deposits portfolio registered a shy expansion of LP 306 billion during the first quarter of the year 2019, moving from LP 47,734 billion at end-December 2018 to LP 48,040 billion at end-March 2019. This followed a large expansion of LP 11,869 billion in 2018, given BDL's operations that have allowed banks to subscribe in longer-term LP Certificates of Deposits against conversion of foreign currency funds into local currency.

Finally, as a measure of disintermediation, the share of LP Tbs held by the public to LP Money Supply (M2) rose slightly from 14.9% at end-December 2018 to 15.0% at end-March 2019, mainly due to a larger contraction in LP Money Supply. As for crowding out effects, the share of the State in bank credits rose from 36.3% at end-2018 to 36.9% at end-March 2019, amid lower bank tendency to lend to the resident private sector (as shown by 3.4% contraction in "claims on resident customers" during the first quarter of the year 2019).

Looking forward, the launch of long-awaited economic and fiscal reforms tied to CEDRE resolutions could send positive signals about Lebanon's resolve to reduce budget deficit, which is increasingly needed to support investor and depositor confidence and help attract inflows into the Lebanese financial sector.

1.4.2. Banking Activity

Renewed rise in deposits following the government formation

Lebanon's banking sector has benefited from an improved sentiment following the government formation with deposits renewing with growth especially during the month of March 2019. Depositors have been comforted by the government's pledges to curb the fiscal imbalances and lately by reform triggers with the approval of the electricity plan and fiscal reform perspectives, while at the same time benefiting from enticing rates on LP savings products. At the same time, banks continue to maintain sound liquidity levels while their appetite for new private sector lending remains constrained in the current low growth environment. All in all, banks operating in Lebanon managed to pull out a 12.5% yearly rise in total assets when comparing the month of March 2019 to the same month a year ago to reach the equivalent of US$ 252.8 billion.

BANKING ACTIVITY

in US$ million	2017	2018	Q1-18	Q1-19	Variation Q1/Q1
Var: Total assets	**15,545**	**29,628**	**4,714**	**3,268**	**-30.7%**
% change in assets	7.6%	13.5%	2.1%	1.3%	-0.8%
Var: Total customer deposits	**6,169**	**5,617**	**2,515**	**-1,758**	**-**
o.w. LP deposits	-2,780	-1,555	1,508	-493	-
o.w. FC deposits	8,950	7,171	1,005	-1,265	-
% change in total deposits	3.8%	3.3%	1.5%	-1.0%	-2.5%
Var: Total credits	**2,506**	**-300**	**-655**	**-2,057**	**-**
o.w. LP credits	2,659	-482	204	-890	-
o.w. FC credits	-152	182	-858	-1,167	-
% change in total credits	4.4%	-0.5%	-1.1%	-3.5%	-2.4%

Banks continued to collect deposits despite looming uncertainties over the covered period while beefing up their liquidity levels. As a matter of fact, the bulk of asset growth stems from rising placements at the Central Bank in the form of deposits. Consequently, their FX primary liquidity ratio as a percentage of FX deposits reached 57.6% at end-March 2019, shedding light on banks' strong buffers against potential deposit withdrawals in times of pressure.

This actually occurred at a time when banks are generally shying away from extending new waves of loans to customers and corporates in the currently prevailing overall economic conditions and looming uncertainties. Banks' loan portfolio to the private sector declined by close to 3% in the 12 months to March 2019, mostly due to a contraction in the LP lending portfolio of the resident sector, noting that the non-resident sector benefited from a slight increase in credit over the covered period.

At the same time, banks continue to benefit from a stable and sticky deposit base accounting for close to 70% of their total balance sheets. Deposits edged up by 1% between March 2018 and March 2019, which is yet not sufficient to finance the country's deficits. However, we note that the month of March 2019 by itself yielded an additional US$ 551 million in deposits for banks, after ameliorating sentiment gave a boost to the deposit base following a decelerating performance in the first month of the year and a stability in February. Out of the additional March deposits, 72% were in foreign currencies and 28% in local currency, and these were almost equally distributed between the resident and non-resident sectors. Anyhow, with the loan-to-deposit ratio at a low 33% at end-March, banks benefit from sufficient firepower to extend new waves of loans to the economy once conditions improve tangibly and sustainably.

In parallel, interest rates in LP have declined in the month of March, thus reflecting eased pressures, after an ascending trend in the past few months in the midst of domestic uncertainties, especially in the lengthy pre-government formation period marked by intensified local political bickering. In fact, while interest rates on LP deposits rose by 265 bps between February 2018 and February 2019, they declined by 41 bps during March to close the month at 8.75%. Rates on US dollar deposits, which had risen less than local currency ones, were mostly stable in March.

In sum, the relatively ameliorated risk profile has allowed banks to renew with deposit growth in March 2019 after subdued growth in the previous few months, which augurs well for sector activity should the government proceed with long-awaited reforms. At the same time, banks display adequate financial standing ratios, with above-peer liquidity ratios, sound capital adequacy metrics and still low (albeit slightly rising) asset quality indicators, thus making sure the country's financial sector steers rather smoothly through the current uncertainties.

1.4.3. Equity and Bond Markets

Relative price stability across Lebanon's capital markets during the first quarter of 2019

Lebanon's fixed income market was marked by price stability during the first quarter of the year 2019, as the losses incurred at the beginning of 2019 were wiped out following the cabinet formation amid bets that the new government would embark into material economic and fiscal reforms. In parallel, Lebanese equities saw mere price retreats during the first quarter of the year amid reduced activity, in a market that suffers from a lack of liquidity and efficiency.

In details, Lebanon's Eurobond prices remained stable during the first quarter of 2019. Price falls observed at the beginning of the year amid lingering concerns over Lebanon's economic and financial outlook and on the back of a credit rating cut by Moody's from "B3/Negative" to "Caa1/stable", were counterbalanced by decent price gains following the formation of a new cabinet at end-January, the Qatari plans to buy US$ 500 million worth of Lebanese Eurobonds and the Saudi pledge to provide full support for the Lebanese economy "all the way".

In fact, after reaching a double-digit level of 12.0% on January 11, 2019, the weighted average bond yield returned at end-March 2019 to its 2018 year-end level of 9.95%, as the positive developments on the domestic political front boosted confidence that the new government would move forward in accessing more than US$ 11 billion in grants and soft loans that were pledged by international donors at CEDRE conference. While shorter-term sovereigns maturing between 2019 and 2024 saw mostly expansions in yields, sovereigns maturing between 2025 and 2037 posted contractions in yields. This was coupled by a relatively reduced market volatility. In fact, based on yield metrics, Lebanese Eurobonds registered a volatility of 13.1% during the first quarter of 2019 as compared to a higher volatility level of 17.8% in 2018.

The favorable mood that swayed over Lebanon's bond market during the first quarter of the year 2019 was extended until the month of April. In fact, the cabinet's approval for the electricity plan, which was later ratified by the Lebanese Parliament, provided ensuring signals to the international community that Lebanon is embarking into material economic and fiscal reforms to reduce its budget deficit. This positive development compounded with domestic calls for austerity measures and the BofA Merrill Lynch recommendation to "Buy" Lebanese Eurobonds, to give a further boost to the Lebanese Eurobond market, bringing the weighted average bond yield down to 9.44% at end-April 2019.

As to the cost of insuring debt, Lebanon's five-year CDS spreads, which hit 901 bps on January 14, 2019 within the context of rising domestic political bickering and increased uncertainties, closed the first quarter of the year 2019 at 841 bps as compared to 770 bps at end-December 2018, and fell further to 797 bps at end-April 2019, in a sign of improved market perception of sovereign risks at large following the cabinet formation and after the new government embarked into plans to reform the electricity sector in the country, which is crucial for reducing fiscal deficit and restoring investor confidence.

In parallel, Lebanese equities registered slight price retreats during the first quarter of 2019 in a market that suffers from a lack of liquidity and efficiency. This was reflected by a 0.8% decline in the BSE price index to close at 83.23 at end-March 2019, down from 83.87 at end-December 2018, despite attractive market pricing ratios. In fact, Lebanese equities traded at a P/E of 6.7 times at end-March 2019 as compared to a much higher P/E of 15.2 times in the MENA region. Seven out of 27 listed stocks registered price drops ranging between 0.1% and 11.1%, while eight stocks posted price gains of 0.2% to 8.6%, and 12 stocks saw no price change during the first quarter of the year. Within this context, it is worth mentioning that Lebanese equities dived further in the red in April 2019, mainly on ex-dividend activity, with the price index closing at 78.46 at the end of the month.

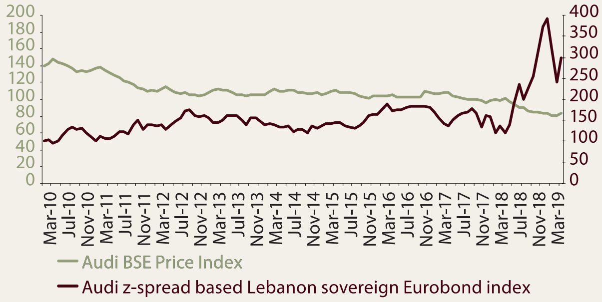
In parallel, the Beirut Stock Exchange saw a reduced activity during the first quarter of 2019. The total turnover reached US$ 79 million as compared to US$ 82 million during the corresponding period of 2018, down by 3.9%. This was mainly driven by a yearly contraction in activity on Solidere and industrial & trading shares. In the absence of listing and de-listing activity during the first quarter of the year 2019, the BSE market capitalization declined by a similar 0.8%, moving from US$ 9,117 million at end-2018 to US$ 9,047 million at end-March 2019. Accordingly, the total turnover ratio, measured by the annual trading value to market capitalization, reached 3.5% during the first quarter of 2019 as compared to 3.0% during the corresponding period of 2018, remaining way behind regional, emerging markets and global turnover ratios.

FINANCIAL SECTOR (NON-BANKS)

	2015	2016	2017	2018	Mar-19
Beirut Stock Exchange					
Market capitalization (in millions of US$)	10,496	10,951	10,578	9,117	9,047
Total trading volume (in millions of US$)	498	885	608	376	79
Annualized trading volume/Market cap.	4.7%	8.1%	5.8%	4.1%	3.5%
Price index	104.6	106.9	98.2	83.9	83.2
% change in index	-1.2%	2.1%	-8.1%	-14.6%	-0.8%
P/E ratio*	6.72	6.44	6.38	5.18	6.67
P/NAV ratio*	0.93	0.91	0.86	0.69	0.68
Lebanese Eurobonds					
Total volume (in millions of US$)	25,535	26,123	26,123	30,964	30,964
Average yield	6.1%	6.5%	6.5%	10.0%	10.0%
Average life (in number of years)	6.1	6.2	6.7	7.8	7.6
5-year CDS spreads variation (bps)	26	57	43	229	71

* For large listed banks

CAPITAL MARKETS PERFORMANCE



2. CONCLUSION: THE SCENARIO OF A FISCAL SOFTLANDING IS STILL PLAUSIBLE LOOKING AHEAD

Looking forward, we believe there is still room for a softlanding scenario in public finance conditions rather than harmful measures with long lasting adverse effects such as devaluation or debt restructuring. There is still room to decrease the budget deficit and restrain debt growth through both revenue and spending measures that would hinge over increasing resource mobilization, improving tax collection, spending austerity, reforming the electricity sector, capturing CEDRE pledges, in addition to well managing the oil and gas resources. The policy statement has committed to decrease deficit to GDP by 1% per annum over the next five years, starting with the 2019 budget, from a deficit ratio of 11% in 2018 the equivalent of US$ 6 billion. A glance at the implications of such a requirement suggests that it could emanate from a number of sources as per the below:

With respect to spending austerity, there is room to decrease variable spending (other than wages, salaries, debt service and EDL) by 20%, as suggested by the Government's policy statement generating savings of US$ 0.9 billion, which is the equivalent of 15% of last year's deficit. A more drastic 40% decrease over a longer term scenario could generate savings of US$ 1.6 billion out of a total variable spending of US$ 4.3 billion.

As to electricity sector reforms, there is room for the sector to become profitable in the medium term, against a US$ 1.7 billion sectoral loss last year. This could be achieved through reforming the sector, building the needed power plants, ensuring 24h electricity and raising electricity tariffs. Those tariffs can increase by no less than 40% (from the current 9.5 cents/kWh to 14 cents per kWh, which would still be below the global average of 19 cents per kWh). Tariff increases could be introduced once the Lebanese would pay a single bill rather than dual bills, bearing in mind that the bill they are paying to generators is circa 25 cents/kWh today.

With respect to reinforcing resource mobilization, it is worth mentioning that Lebanon is still an undertaxed economy, with a resource mobilization ratio of 19%, against 26% in developing countries and 36% in advanced countries. While increasing taxes is still subject to political bickering inside the country because of the additional social pressures that it could generate in a low growth economy, we believe that as a prerequisite to any tax increase, Lebanon needs to ensure that public sector corruption is gradually reduced for any additional taxes to be generally accepted by the Lebanese public at large. The efforts currently undertaken to fight corruption are welcomed but need to be complemented by more stringent measures across the public administration.

As to fighting tax evasion, we believe there is room to bridge over the next five years no less than a quarter of the tax evasion gap that we estimate at US$ 4.8 billion per annum emanating mainly from income taxes, electricity bills, VAT, customs and property taxes. This would result in additional annual proceeds of US$ 1.2 billion, the equivalent of 2.25% of GDP, almost half what Lebanon has committed to in CEDRE as a 5-year fiscal deficit adjustment.

Finally, in case all those measures are implemented, there will be no material deficit in public finances in the middle run. In case only half of those measures take place because of domestic political conflict, there is still room to decrease the budget deficit from 11% of GDP to 5.5% of GDP at a 5-year horizon and realize a softlanding scenario in public finance conditions. This suggests that fiscal figures are still manageable and the country did not fall into a debt trap yet, despite the worrisome fiscal standing at the current juncture. Of course all this requires a minimum of political stability and political consensus among policy makers, but whose likelihood has somewhat improved following the recent long awaited Cabinet formation. This calls upon all the political class to embark on tough choices within the context of much needed adjustment reforms that would ensure Lebanon would avoid the bitter cup of an appalling no-action scenario with the adverse effects that it could leave on the country's long term economic stability at large.

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