LEBANON ECONOMIC REPORT

FOR A RE-ALIGNMENT OF GROWTH WITH ITS LONG-TERM POTENTIAL

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"By the finalization of this report, Lebanon had witnessed the appointment of a Government of National Unity, putting an end to 8 months of political deadlock since last May's parliamentary elections, thus leading to favorable reactions on behalf of the international community and generating a rally in domestic capital markets at large as witnessed by the contraction in eurobond yields and CDS spreads and the trend reversal on the FX and money markets. The following report covers the full-year 2018, i.e prior to the recent long-awaited Cabinet formation."

- Tough real sector conditions in 2018

The real sector of the Lebanese economy has witnessed relatively tough conditions in 2018 while the financial sector continues to grow moderately. The IMF has revised down its 2018 real growth for Lebanon to 1% from a previous forecast of 1.5%. BDL estimates Lebanon's 2018 growth within a range of 1%-1.5%. While 2018 has seemingly reported a further slowdown in growth, it is still non-recessionary in the technical definition of recession, i.e negative growth or net contraction in Lebanon's real economy. The further slowdown in 2018 is related to the overall wait-and-see attitude characterizing private sector investors refraining from investing in Lebanon's various economic sectors, while private consumption managed to continue growing moderately.

- Moderate rise in foreign trade deficit amid slightly growing exports and imports

Lebanon's external sector witnessed a moderate increase in total foreign trade activity by 2.8% over the first eleven months of 2018 as a result of increasing imports by 2.5% and exports by 4.3%. Accordingly, the trade deficit went up by 2.2%, from US$ 15.4 billion to US$ 15.7 billion between the two periods. In parallel and within the context of a contraction in financial inflows to Lebanon and a positive growth in trade deficit over the first eleven months of 2018, the balance of payments recorded a rising deficit over the period.

- 2018 sees quasi-stability in BDL's foreign assets and first increase in LP Tbs rates

Amid persistent domestic political tensions, Lebanon's monetary conditions witnessed in 2018 net foreign currency conversions on the foreign exchange market, quasi-stability in the Central Bank's foreign assets despite cash settlement of maturing bonds and higher interest rates on LP-denominated securities. The Central Bank of Lebanon's foreign assets slightly contracted by US$ 2.3 billion in 2018 to reach US$ 39.7 billion at end-December. BDL's foreign assets-to-LP money supply coverage ratio recorded 77.1% at end-2018, remaining well above the average of reserve adequacy in similarly rated countries (41.6%). The overnight rate saw strong fluctuations over the second half of 2018 amid a lack of local currency liquidity on the money market, reaching a high of 75% in December, before sliding to regular single-digit levels towards the end of January 2019 following Gulf support pledges and successful Cabinet formation.

- Sound banking liquidity position and satisfactory deposit growth in a difficult year

Lebanese banks have gone through a difficult year in 2018, amid domestic political tensions and the lack of a government formation for the better part of the year. Nonetheless, confidence in the banking system and the sticky deposit base, coupled with banks' sound liquidity at hand, have allowed the sector to withstand difficult times and post a net growth in deposits, its traditional engine of growth. Customer deposits, accounting for 70% of the total balance sheets, rose by a moderate 3.3% in 2018, the equivalent of US$ 5.6 billion (US$ 6.8 billion when including financial sector and public sector deposits), after a strong month of December (partly favored by window-dressing), while Lebanese banks' foreign liquidity position relatively strengthened during the year.

- A 2.5% real GDP growth forecast for 2019 post cabinet formation driven by consumption, infrastructural spending and exports

Our macro forecasts for 2019 are based on a 2.5% real GDP growth forecast (a 6% nominal growth) following the recent Cabinet formation, and based on a slow progress in CEDRE reforms and implementation. Nominal growth would be driven by: (1) a 6.5% domestically driven growth in private consumption; (2) while private investment is likely to stagnate at its 2018 level amid politico-economic uncertainties weighing on private investors initiatives; (3) a double-digit growth in public investment from a relatively low base within the context of the State's new Capital Investment Program; (4) along with a 14% growth in exports on the basis of the recent reopening of Syrian/Jordanian routes for Lebanese land exports. In parallel, Money Supply would grow by 4% on the back of an 8% growth in financial inflows that would somewhat reduce the balance of payments deficit.

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The real sector of the Lebanese economy has witnessed relatively tough conditions in 2018 but the financial sector continues to grow moderately. The IMF has revised down its 2018 real growth for Lebanon to 1% from a previous forecast of 1.5%. BDL estimates Lebanon's 2018 growth within a range of 1%-1.5%. While 2018 has seemingly reported a further slowdown in growth, it is still non-recessionary in the technical definition of recession, i.e negative growth or net contraction in Lebanon's real economy.

The further growth slowdown in 2018 is related to the overall wait-and-see attitude characterizing private sector investors refraining from investing in Lebanon's various economic sectors within the context of politico-economic uncertainties. Private consumption managed to continue growing moderately (especially benefitting last year from the public sector wage scale) and rising government spending provided a tiny support to growth.

Out of 11 real sector indicators, 5 are up and 6 are down 2018 relative to 2017. Among indicators with positive growth, we mention the number of passengers at the Airport with an expansion of 7.4%, the number of tourists with a rise of 5.8%, total exports with a growth of 4.3%, total imports with an increase of 2.5% and electricity production with a growth of 1.2%. Among indicators with negative growth, we mention construction permits with a fall of 23.1%, value of property sales with a contraction of 18.3%, new car sales with a decline of 11.3%, merchandise at the Port with a fall of 7.5%, cement deliveries with a decrease of 5.3% and cleared checks with a decline of 2.5% year-on-year.

At the banking level, Lebanon's customer deposits managed to grow by US$ 5.6 billion in 2018 (US$ 6.8 billion when including financial sector and public sector deposits), against US$ 6.2 billion in 2017. In particular, non-resident deposits grew by US$ 2.6 billion, against US$ 1.2 billion in the previous year. At the level of lending however, banks loans to the private sector almost stagnated in 2018, against a growth of US$ 2.5 billion in 2017 and an average growth of US$ 3.2 billion in the past five years.

The considerable improvement in non-resident deposit growth partially explains the widening balance of payments deficits between the past two years. The balance of payments recorded a deficit of US$ 4.8 billion in 2018, compared to US$ 156 million in 2017, amid contracting inflows and widening trade deficit.

At the fiscal level, a net deterioration was reported in public finance conditions, following the relative improvement of the previous year. Lebanon's public finance deficit actually rose from US$ 2 billion over the first nine months of 2017 to US$ 4.5 billion over the first nine months of 2018, within the context of a 27% growth in public expenditures and a 3% rise in public revenues. Public debt in parallel reached US$ 84 billion, the equivalent of 148% of GDP.

At the capital markets level, equity and bond markets came under pressure in 2018. Domestic political uncertainties along with emerging market weakness took a heavy toll on the Lebanese Eurobond market. The weighted average yield rose by 341 bps in 2018 to reach 9.95%, falling from a peak level of 11.23% mid-September 2018. Lebanon's five-year CDS spreads closed the year at 750 bps, up by 249 bps, after crossing above the 800 bps threshold several times during the second half of the year. On the equity market, the BSE saw a 15% drop in prices in 2018 amid increased price volatility, while the total turnover contracted by circa 38% year-on-year.

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 the near term outlook looking forward.

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture and Industry

Primary and secondary sectors close 2018 on a slightly improving note

Lebanon's agricultural and industrial sectors closed 2018 on a slightly improving note, showing few signs of relative recovery. Despite domestic political uncertainty, 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.

On the agricultural front, the sector witnessed an expansion from the past year, with both imports and exports improving. Agricultural exports increased by 8.4% during the first eleven months of 2018, against a decline of 0.5% in the same period of the previous year. Agricultural imports also rose by 8.1% to satisfy local demand during 11M 2018, compared to a rise of 8.4% in the same period of 2017.

Moving on to the industrial sector, it was on a growth trend during the past year, as the rate of both imports and exports slightly recovered. As a matter of fact, imports of the industrial sector grew by 1.9% annually in the first eleven months of 2018 after rising by 1.7% in 11M 2017. Externally, industrial exports also rose by 3.8% from the previous year's level during 11M 2018, against a drop of 5.4% in the same period of 2017.

It is worth noting that agricultural and industrial 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. For instance, merchandise that required 20 days to reach Gulf markets through sea would need significantly less time to reach destination.

At the same time, the country's bank financing for small and medium-sized enterprises through Kafalat loans continued declining, witnessing a further contraction in the first six months of 2018. According to the latest data available, the total value of Kafalat loans fell by 24.4% year-on-year to reach US$ 28.8 million in the aforementioned period of this year. The number of Kafalat loans also dropped by 28.1% year-on-year. In details, financing to the agricultural sector saw a decline of 35.7% year-on-year in the first six months of 2018, and financing to the industrial sector decreased by 20.8% year-on-year.

Furthermore, the Ministry of Industry (MoI) issued 476 industrial permits in the first six months of 2018, a 45% increase compared to the same period of last year. These include new establishment licenses, expansion approvals, exploitation permits, and renewals. The MoI issued 139 licenses for the establishment of new factories. The majority of these factories produce pickles, spices, and traditional sweet beverages. The MoI also issued a number of licenses for water bottling plants, whose licensing used to be under the authority of the Ministry of Public Health.

On another note, it is worth noting that the European Bank for Reconstruction and Development (EBRD) launched the "Advice for Small Business Program for Lebanon", which would support a number of sectors including the agricultural and industrial sectors. The program targets small and medium-sized enterprises (SMEs), which comprise about 90% of the business activity in the local private sector. The multilateral bank would provide, through the program, a wide spectrum of business advisory services such as strategic planning, marketing, operations management, quality management, energy efficiency, and financial management.

Last but not least, Lebanon's primary and secondary sectors are expected to further benefit going forward from the reopening of some trade routes and Syria's reconstruction efforts. The opening of the Nassib crossing border between Syria and Jordan is increasingly expected to affect the growth of industrial and agricultural exports in the year ahead.

1.1.2. Construction

Real estate sector facing difficult conditions in 2018

Lebanon's real estate market witnessed a slump in 2018 with all of its indicators declining. Decelerating demand due to the subsidized housing loans issue coupled with domestic politico-economic uncertainties came to put extra pressure on the sector.

In this context, realty markets have undergone a decrease in property transactions and sales activity. The number of sales operations retreated by a yearly 17.4% from 73,541 sales operations in 2017 to 60,714 operations in 2018. This counteracted the increase of 14.5% reported in 2017. Furthermore, sales to foreigners fell by 11.0% year-on-year from 1,364 in 2017 to reach 1,214 operations in 2018.

Additionally, the value of property sales transactions was also on a downward path in 2018. It posted a decline of 18.3% year-on-year to attain a total of US$ 8,134.3 million during 2018. Most of the regions recorded declines in the value of sales transactions, with the most significant movements coming as follows: North (-31.7%), Baabda (-22.4%) and Metn (-22.1%). Average sales value declined from US$ 135,356 in 2017 to US$ 133,977 in 2018, reversing the increasing trend a year earlier.

On the supply side, the industry followed the demand patterns, and with the prolonged deterioration in the market, construction works were delayed or somewhat stopped waiting for an amelioration in market conditions. According to the figures provided by the Order of Engineers of Beirut and Tripoli, construction permits, an indicator of forthcoming construction activity, posted a 23.1% year-on-year decrease during 2018. This came after a decline of 4.1% reported in 2017.

Construction permits covered an area of 9,019,583 square meters in 2018, against an area of 11,730,386 square meters in 2017. The breakdown by region shows that most of the regions reported contractions in construction permits, with Beirut and Mount-Lebanon reporting the highest contractions of 48.9% and 25.6% respectively in construction permits in 2018.

As for the breakdown of construction permits, Mount-Lebanon continued to capture the highest share in newly issued construction permits in 2018 with a share of 38.8%. It was followed by the North with a share of 21.6%, South-Lebanon with 16.7%, Bekaa with 9.6%, Nabattiyeh with 9.3% and Beirut with 4.0%.

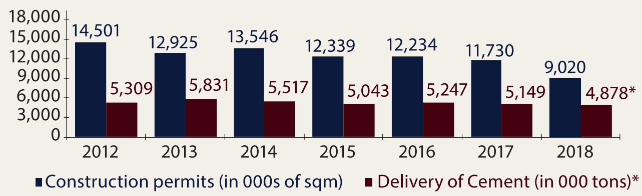
Moreover, cement deliveries, a coincident indicator of current construction activity, adopted a declining trend as well, falling by a yearly 5.3% to reach 4,478,573 tons in the first 11 months of 2018, retreating from 4,722,072 tons in the same period of 2017.

Hence, it is obvious that the real estate market, which was already slowing down in the previous few years, faced more difficult conditions in all of its components in 2018.

CONSTRUCTION

	Q4-17	2017	Q4-18	2018	Variation Q4/Q4	Variation 18/17
Value of property sales (in millions of US$)	2,933	9,954	2,293	8,134	-21.8%	-18.3%
Number of property sales	21,548	73,541	17,451	60,714	-19.0%	-17.4%
o.w. Sales to foreigners	441	1,364	369	1,214	-16.3%	-11.0%
Average value per property sale (in US$ 000)	136	135	131	134	-3.5%	-1.0%
Property taxes (in millions of US$)	169	550	122	414	-28.1%	-24.7%

EVOLUTION OF CONSTRUCTION INDICATORS



* 11-month annualized figure

1.1.3. Trade and Services

Lebanon's tertiary sector sees mixed performance in past year

Lebanon's tertiary sector witnessed mixed results in 2018, performing well at the level of tourist activity while mildly coming under pressure at the level of hospitality, maritime trade, and domestic spending.

To begin with, the number of tourists along with that of Lebanese expatriates spending their vacations in their home country had a positive impact on the country's airport activity. The number of passengers at the Airport rose by 7.4% in 2018, driving a 5.8% yearly increase in tourism activity in 2018 following an increase of 10.0% posted in the previous year. In fact, the number of tourists registered 1,963,917 in 2018, compared to 1,856,795 tourists posted in 2017.

In details, Europe and Arab countries got the lion's share in the contribution to the number of tourists with 35.9% (705,969 tourists) and 28.6% (562,535 tourists) respectively. These were followed by tourists from America which took over a share of 18.2% (357,764 tourists). Tourists from Asia came in after with a share of 7.2% (140,716 tourists), while those of Africa followed with a share of 5.5% (108,608 tourists).

In parallel, according to Global Blue, tax free spending grew by 6.5% in 2018, suggesting improved touristic spending within the context of rising touristic activity.

Nonetheless, improving activity on the tourism front was not directly reflected on the hotel sector. According to Ernst & Young's "Middle East Hotel Benchmark Survey", the performance of Lebanon's hospitality sector witnessed a slowdown in occupancy rates, while an improvement in average room rates and room yields was seen.

As a matter of fact, the occupancy rate of four and five star hotels within the capital reached 64.6% in the first eleven months of 2018, against 64.7% in the aforementioned period of 2017. The occupancy rate within Beirut was the fifth highest among 14 cities included in the survey. Beirut's room rate slightly moved up from the same period of 2017 to an average of US$ 186 in the first eleven months of 2018. The city's growth rate ranked fifth out of 14 surveyed cities. The rate of the capital's hotels was the fourth highest in the region. The rooms' yield rose by 0.8% annually to reach US$ 120 in the first eleven months of 2018 compared to US$ 119 in the same period of 2017. Beirut ranked fifth highest in terms of variation in the region when assessing this indicator.

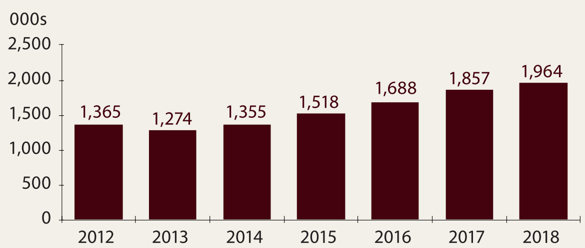
Moving on to maritime trade, the Port of Beirut revealed a yearly 3.5% decrease in the Port's revenues in 2018 compared to the previous year. The Port's revenues actually reached US$ 231.5 million in 2018, down from US$ 240.0 million in 2017. In parallel, the number of containers recorded an annual fall of 2.6% to attain a total of 874,246 in 2018. The number of ships reported a yearly decline of 1.9% to stand at a total of 1,872 vessels in 2018. The quantity of goods decreased by a yearly 7.5% to 7,985 thousand tons in 2018, following a fall of 1.2% reported in 2017.

In conclusion, the total value of cleared checks, an indicator of consumption and investment spending in the Lebanese economy, declined by 2.5% year-on-year in 2018 pointing to a relative deceleration in spending during the aforementioned period. The value of cleared checks reached US$ 66,560 million in 2018, against US$ 68,236 million in 2017.

TRADE AND SERVICES

	Q4-17	2017	Q4-18	2018	Variation Q4/Q4	Variation 18/17
Number of ships at the Port	499	1,909	459	1,872	-8.0%	-1.9%
Number of containers at the Port (in 000s)	237	898	220	874	-7.2%	-2.6%
Merchandise at the Port (in 000 tons)	2,228	8,629	2,039	7,985	-8.5%	-7.5%
Planes at the Airport	16,569	71,171	17,099	73,626	3.2%	3.4%
Number of passengers at the Airport (excluding transit, in 000s)	1,836	8,231	1,990	8,838	8.4%	7.4%
Cleared checks (in millions of US$)	17,961	68,236	16,912	66,560	-5.8%	-2.5%

EVOLUTION OF THE NUMBER OF TOURISTS



1.2. EXTERNAL SECTOR

Moderate rise in foreign trade deficit year-on-year

Lebanon's external sector witnessed a moderate increase in total foreign trade activity by 2.8% over the first eleven months of 2018 compared to the first eleven months of 2017, moving from US$ 20.6 billion to US$ 21.1 billion, according to trade statistics released by Lebanon's Customs Authority. This relatively modest rise in trade activity was the result of increasing imports by 2.5% and exports by 4.3%. Accordingly, the trade deficit went up by 2.2%, from US$ 15.4 billion to US$ 15.7 billion between the two periods.

In parallel and within the context of a contraction in financial inflows to Lebanon and a positive growth in trade deficit over the first eleven months of 2018 relative to the same period of 2017, the balance of payments recorded a rising deficit of US$ 4.8 billion in 2018, against a deficit of US$ 156 million in 2017. The latter was triggered by a decline of US$ 2.5 billion in banks' net foreign assets, coupled with a decline in BDL's net foreign assets by US$ 2.3 billion in 2018.

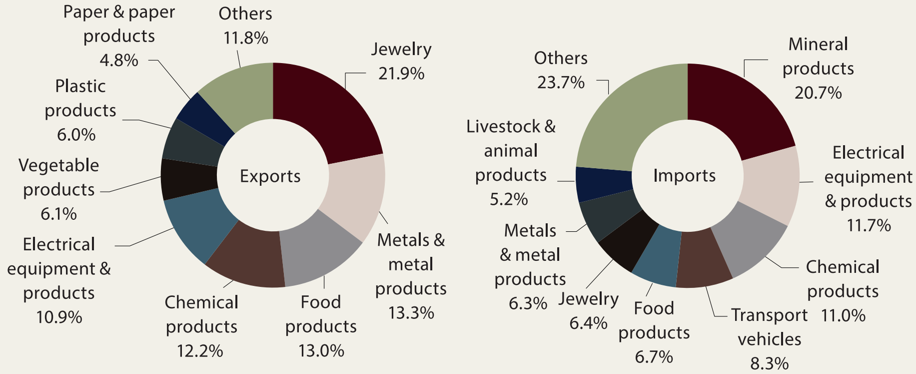
Going further into details, total exports reached US$ 2.7 billion over the first eleven months of 2018, from US$ 2.6 billion in the first eleven months of 2017. It is worth mentioning that exports through the Hariri International Airport went up by 8.1% and those through the Port of Beirut witnessed an increase by 4.6% over the same period, while land exports through Syria decreased by 22.2% moving from US$ 225 million to US$ 175 million.

The analysis of exports by major products suggests that exports of plastic products reported a yearly growth of 19.9% over the first eleven months of 2018, followed by metals and metal products with 18.0%, chemical products with 12.3% and jewelry with 10.8%. In parallel, exports of food products declined the most among the major products with a drop of 15.8%, followed by papers and paper products with a decline of 0.8% between the two periods.

The breakdown of exports by country of destination suggests that the most significant increase was reported in exports to UAE with 83.0%, followed by exports to Qatar with 38.6%, exports to Turkey with 19.4% and to Egypt with 8.6%. In parallel, exports to South Africa reported a 44.1% decline, followed by Syria with -20.1%, Iraq with -15.7%, Kuwait with -15.3% and Saudi Arabia with -12.8% over the first eleven months of 2018 relative to the same period of 2017.

The breakdown of imports by major products suggests that the most significant increase was reported in jewelry with 35.7%, electrical equipments with 21.5%, livestock and animal products with 17.4%, chemical products with 4.2% and vegetable products with 1.4%. In parallel, imports of transport vehicles

BREAKDOWN OF EXPORTS AND IMPORTS BY COMMODITY*



* 11M-18

reported a 10.5% decline, followed by cement and stone products with -8.0% and mineral products with -5.4% over the first eleven months of 2018 relative to the same period of 2017.

The breakdown of imports by country of origin suggests that the most significant increase was reported in imports from UAE with 71.5% over the period, KSA with 35.4%, Switzerland with 34.5%, Greece with 26.2%, Turkey with 22.5% and China with 10.1%. In parallel, imports from Russia reported a 20.4% decline, followed by Italy with -10.1%, France with -7.4% and USA with -4.2% over the first eleven months of 2018 relative to the same period of 2017.

1.3. PUBLIC SECTOR

Surge in public debt and deficit ratios, though still below previous peaks

Public finance statistics for the first nine months of 2018 released by the Ministry of Finance suggest a relative surge in fiscal deficit. Lebanon's public finance deficit rose to US$ 4.5 billion over the first nine months of 2018, within the context of a 27% growth in public expenditures and a 3% rise in public revenues. The growth in public expenditures is tied to the public sector wage scale which cost exceeded preset figures, while the insignificant rise in public revenues, despite the tax hikes of the last quarter of 2017, is tied to economic sluggishness amid weak real sector activity, in addition to the high revenue base effect of the previous year driven by the one-off tax on financial engineering operations.

The rise in public spending comes within the context of a 56% rise in Treasury spending and a 24% rise in budget spending over the first nine months of 2018 relative to the same period in 2017. In turn, the growth in budget spending is tied to a 34.2% rise in general expenditures (mainly wage increases), a 38% rise in EDL deficit and an 8% rise in debt servicing. Net of debt servicing, the primary balance reported a deficit of US$ 0.6 billion over the first nine months of the year.

The growth in public revenues comes within the context of a 13% rise in Treasury revenues and a 2% rise in budget revenues. In turn, the rise in budget revenues is driven by a 23% growth in Telecom revenues, an 11% rise in VAT revenues while customs revenues declined by 4% and miscellaneous tax revenues dropped by 1% over the first 9-month period.

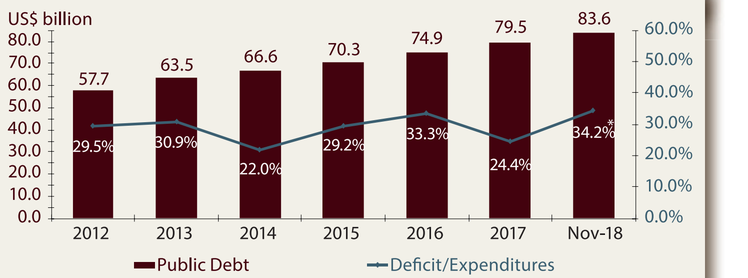
The analysis of the US$ 4.5 billion 9-month fiscal deficit by quarter suggests that the first quarter reported the largest deficit of US$ 1.8 billion (40% of public expenditures), followed by the third quarter with US$ 1.5 billion (35% of public expenditures) and finally the second quarter with US$ 1.2 billion (27% of public expenditures). As such, the 9-month deficit reported an average of 34% of government expenditures, the equivalent of 10.6% of GDP. It is worth mentioning that while the fiscal deficit emerges as a key vulnerability of the Lebanese State and needs to be urgently curbed, it is still lower than the previous recent peaks attained a decade ago, bearing in mind that Lebanon was able to maintain its financial stability back then under more worrisome public finance conditions.

In parallel, the data published by Lebanon's Ministry of Finance showed that the country's gross debt reached US$ 83.6 billion at end-November 2018, up by 5.2% from the level seen at end-2017. Domestic debt was higher by 2.3% from end-2017 to reach a total of US$ 50.3 billion at end-November 2018.

PUBLIC SECTOR DEFICIT FINANCING

in millions of US$ **Deficit financing**	9M-17 Vol	9M-18 Vol	Progression Vol
Deficit	2,003	4,508	2,504
State creditor accounts	692	14	-678
Other items	569	-203	-772
Uses=sources	**3,264**	**4,319**	**1,055**
LP	**1,544**	**-710**	**-2,254**
Treasury bills (banking system)	1,171	-776	-1,947
Others	373	66	-307
FX	**1,720**	**5,029**	**3,309**
Sovereign eurobonds (including Paris II bonds)	1,251	4,739	3,488
Others	469	290	-179

PUBLIC INDEBTEDNESS



* 9 months figures

Lebanon's foreign debt grew by 9.8% from end-2017 to stand at around US$ 33.4 billion at end-November 2018. In this context, the public sector deposits at the Central Bank declined by 28.2% from end-2017 to stand at US$ 4.2 billion at end-November 2018. The public sector deposits at commercial banks edged up by 2.3% from end-2017 to reach US$ 4.4 billion at end-November 2018. As such, net public debt, which excludes the public sector deposits at the Central Bank and commercial banks from overall debt figures, increased by 8.2% from end-2017 to reach a total of US$ 75.0 billion at end-November 2018. Accordingly, net domestic debt amounted to US$ 41.7 billion at end-November 2018, up by 7.0% from end-2017. Relative to the size of the domestic economy, public debt to GDP is estimated at 148.0% as at end-November 2018, extending its rise of the past few years, though remaining below the 185% level reached a decade ago.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

2018 sees quasi-stability in BDL's foreign assets and first increase in LP Tbs rates

Amid a protracted cabinet formation deadlock and heightened domestic political tensions, Lebanon's monetary conditions witnessed in 2018 net foreign currency conversions on the foreign exchange market, quasi-stability in the Central Bank's foreign assets despite cash settlement of maturing bonds, higher interest rates on LP-denominated securities and a significant expansion in LP Certificates of Deposits portfolio issued by BDL.

The Central Bank of Lebanon's foreign assets slightly contracted by US$ 2.3 billion in 2018 to reach US$ 39.7 billion at end-December. This is mainly attributed to the redemption of three US dollar-denominated and Euro-denominated bonds totaling circa US$ 2,230 million in June and November 2018, and a wave of net foreign currency conversions during the second half of the year 2018 amid heightened cabinet formation uncertainties, which outweighed the positive impact of May 2018's swap operations. Under these conditions, the Central Bank of Lebanon Governor reiterated several times that the "Lebanese pound is stable and the Central Bank has the means to defend its stability", highlighting that monetary stability would be reinforced once long-awaited reforms are initiated to bring down the budget deficit.

That being said, the BDL's foreign assets-to-LP money supply coverage ratio reached 77.1% at end-December 2018 against 80.0% at end-December 2017, remaining well above the average of reserve adequacy in similarly rated countries (41.6%), which sheds light on the Central Bank of Lebanon's strong ability to safeguard the currency peg.

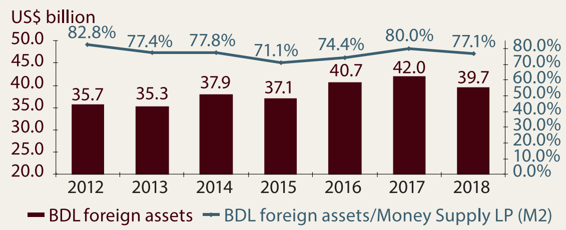
The overnight rate, a mirror image of the foreign exchange market activity, saw strong fluctuations over the second half of 2018 amid a lack of local currency liquidity on the money market, reaching 75% during December, which is its highest level since PM Hariri's resignation in November 2017, before sliding to 35% at the end of the year 2018, and returning to its regular single-digit levels towards the end of January 2019 following Gulf support pledges.

In parallel, the financial system's total subscriptions in LP Treasury bills amounted to LP 28,557 billion in 2018 against LP 27,216 billion in 2017, up by 4.9% year-on-year. These included LP 8,250 billion worth of subscriptions made by the Central Bank of Lebanon during June-November 2018 period in the three-year, five-year, seven-year and ten-year categories at a yield of 1%, within the context of May 2018's swap

MONETARY SITUATION

Flows in US$ million	2017 Vol	2018 Vol	Progression Vol
Net foreign assets (excluding gold)	-1,619	-4,938	-3,319
Net claims on the public sector (excluding valuation adjustments)	974	4,118	3,144
Claims on the private sector	3,318	-1,939	-5,257
Uses=Sources	**2,673**	**-2,759**	**-5,432**
Money (M3)	5,586	2,672	-2,914
Valuation adjustment and other items	-2,913	-5,431	-2,518

EXCHANGE MARKET INDICATORS



operations that required the Central Bank of Lebanon to exchange the equivalent of US$ 5.5 billion of LP Treasury bills in its LP securities portfolio with newly-issued Eurobonds, while subscribing in LP Tbs at 1% interest rate. Within this context, it is worth mentioning that the Central Bank of Lebanon's LP securities portfolio grew by LP 2,361 billion in 2018, as compared to a wider expansion of LP 5,165 billion in 2017.

As to interest rates, Lebanon's Ministry of Finance started in December 2018 lifting LP interest rates, through the launching of two special Tbs issues in the 10-year and 15-year categories at coupons of 10.0% and 10.50% respectively against previous coupons of 7.46% and 7.90% respectively, while allowing subscribers to conduct exchange operations between LP term deposits held at BDL or LP Certificates of Deposits issued by BDL, and these Tbs issues. Interest rate hikes were extended to January 2019, with the Ministry of Finance lifting rates on the three-month to seven-year Tbs categories at a range of 0.86% to 1.92%, after maintaining stability in interest rates for more than six years.

On the other hand, the total LP Certificates of Deposits portfolio expanded significantly by LP 11,869 billion in 2018 to reach LP 47,734 billion at end-December, mainly helped by BDL's operations, which allowed banks to subscribe in longer-term LP Certificates of Deposits against conversion of foreign currency funds into local currency. This followed a much lower growth in LP CDs portfolio of LP 1,234 billion in 2017.

Finally, as a measure of disintermediation, the share of LP Tbs held by the public to LP Money Supply (M2) reached 14.9% at end-December 2018, up from 13.6% at end-2017, driven by a yearly expansion in LP Tbs held by the public and a contraction in LP money Supply (M2). As for crowding out effects, the share of the State in bank credits rose from 34.9% at end-2017 to 36.3% at end-December 2018, mainly reflecting banks' purchase of US$ 3 billion Eurobonds from BDL and a lower bank tendency to lend to the resident private sector amid a sluggish domestic economic activity (as mirrored by a 3.1% contraction in "claims on resident customers" over the year 2018).

Looking forward, following the successful cabinet formation, an initiation of fiscal reforms tied to CEDRE resolutions is set to further improve the confidence factor in Lebanon, triggering a trend reversal on capital market, an increase in inflows into the financial sector and a rebound in the coverage ratio of net foreign assets-to-broad monetary base.

1.4.2. Banking Activity

Sound liquidity position and satisfactory deposit growth in a difficult year

Lebanese banks have gone through a difficult year in 2018, amid domestic political tensions and the lack of a government formation for the better part of the year. Nonetheless, confidence in the banking system and the sticky deposit base, coupled with banks' sound liquidity at hand, have allowed the sector to withstand difficult times and post a growth -albeit more modest than in previous years- in deposits, its traditional engine of growth.

BANKING ACTIVITY

	2017					2018					Variation	
in US$ million	Q1	Q2	Q3	Q4	2017	Q1	Q2	Q3	Q4	2018	Q4/Q4	18/17
Var: Total assets	**1,444**	**2,408**	**5,261**	**6,432**	**15,545**	**4,714**	**10,034**	**6,513**	**8,367**	**29,628**	**30.1%**	**90.6%**
% change in assets	0.7%	1.2%	2.4%	3.0%	7.6%	2.1%	4.5%	2.8%	3.5%	13.5%	0.5%	5.9%
Var: Total customer deposits	**1,857**	**3,379**	**1,360**	**-427**	**6,169**	**2,515**	**2,139**	**618**	**345**	**5,617**	**-**	**-8.9%**
o.w. LP deposits	118	183	125	-3,206	-2,780	1,508	467	-1,054	-2,476	-1,555	-	-
o.w. FC deposits	1,739	3,196	1,235	2,780	8,950	1,005	1,673	1,671	2,822	7,171	1.5%	-19.9%
% change in total deposits	1.1%	2.1%	0.8%	-0.3%	3.8%	1.5%	1.2%	0.4%	0.2%	3.3%	0.5%	-0.5%
Var: Total credits	**-532**	**1,309**	**496**	**1,233**	**2,506**	**-655**	**527**	**-136**	**-36**	**-300**	**-**	**-**
o.w. LP credits	667	809	540	643	2,659	204	307	-54	-939	-482	-	-
o.w. FC credits	-1,198	500	-44	590	-152	-858	219	-82	903	182	-	-
% change in total credits	-0.9%	2.3%	0.9%	2.1%	4.4%	-1.1%	0.9%	-0.2%	-0.1%	-0.5%	-2.2%	-4.9%

Measured by the aggregated assets of banks operating in the country, banking sector activity grew by 13.5% to reach the equivalent of US$ 250 billion at end-2018. Customer deposits, the major activity driver accounting for 70% of the total balance sheets, rose by a moderate 3.3% in 2018, the equivalent of US$ 5.6 billion, after a strong month of December (partly favored by window-dressing). It is worth noting that total deposits, including customer deposits, financial sector deposits and public sector deposits, rose by US$ 6.8 billion in 2018.

Customer deposit growth during 2018 was accounted for by foreign currencies with a 6.2% growth while Lebanese pound deposits posted a 2.9% contraction year-on-year. Having said that, the deposit dollarization ratio rose to reach 70.6% by year-end, against 68.7% at end-2017, thus outpacing for the first time the 70% threshold since October 2008. Close to half of new deposits were accounted for by the non-resident sector which accounts for 22% of the total deposit base in Lebanon (against a share in growth of 19% in the previous year).

Higher interest rates (which is also a trend globally) have helped entice deposits during 2018. The sector's average LP term deposit interest rate reported 9.13% in December 2018 (rising by 222 bps on an annual basis), while the sector's average US$ term deposit interest rate reported 5.76% (rising by 134 bps on an annual basis).

It is worth noting that the US$ 5.6 billion annual deposit growth is enough to meet the borrowing needs of the Lebanese economy in its private and public sector components especially that banks are not lending to the private sector. Banks loans to the private sector contracted by US$ 300 million last year or 0.5%, against a growth of US$ 2.5 billion in 2017 and an average growth of US$ 3.2 billion in the past five years. As to the breakdown by residence, loans to residents contracted by US$ 1.3 billion in 2018 while loans to non-residents increased by US$ 1.0 billion.

It is worth noting that despite the further slowdown in domestic economic activity, the asset quality of banks remains favorable and NPLs contained. The BDL Governor recently disclosed a small increase in the NPLs to total loans ratio from 3.2% at end-2017 to 3.8% at end-2018.

Banks' liquidity position strengthened further during 2018. In particular, banks' liquidity in foreign banks reported a net improvement towards the end of the year, partly benefitting from the BDL cash settlement of two Eurobonds maturing during the month of November for a total of US$ 1.5 billion. As such, banks liquidity in foreign banks rose from US$ 9.6 billion in October to US$ 11.2 billion in November and to US$ 12.0 billion in December, thus replenishing all the FX liquidity lost during the year and exceeding its end-2017 level (US$ 11.3 billion). It is worth mentioning that banks' liquidity at foreign banks, coupled with banks' deposits at BDL, constitute around half of customers FX deposits, highlighting the relatively liquid nature of the overall system.

1.4.3. Equity and Bond Markets

Lebanon's capital markets under downward price pressures in 2018 amid domestic uncertainties

Lebanon's capital markets saw noticeable price falls and increased volatility in 2018 amid months-long cabinet formation stalemate and concerns about heightened domestic political disputes that delay the implementation of CEDRE resolutions and leave an adverse impact on Lebanon's economic and financial outlook, while also tracking interest rate hikes by the US Federal Reserve and weaknesses in emerging markets on fears of a global economic slowdown.

In details, a prolonged cabinet formation gridlock and rising concerns over a protracted delay in fiscal reforms tied to CEDRE resolutions, compounded with emerging market weakness (as reflected by a 38% expansion in the JP Morgan EMBIG Z-spread in 2018), took a heavy toll on the Lebanese Eurobond market amid net international selling operations and increased volatility. Yet, the market received a boost towards the end of January 2019 after Qatar announced plans to buy US$ 500 million worth of Lebanese Eurobonds and Saudi Arabia pledged to provide full support for the Lebanese economy "all the way", and following the successful long awaited cabinet formation.

Lebanese sovereigns saw yearly price contractions across the board in 2018, with papers maturing between 2019 and 2037 recording price falls ranging between 0.63 pt and 18.75 pts. This was coupled with increased market volatility. In fact, based on yield metrics, Lebanese Eurobonds registered high volatility levels of 17.8% in 2018, compared to a volatility of 9.1% in the previous year. Sovereigns maturing in April 2021 and January 2023, which are among the most liquid papers on the Lebanese Eurobond market, attained a high volatility level of 21.3% and 19.1% respectively in 2018, relative to much lower volatility levels of 11.2% and 9.1% respectively in 2017.

Within this context, the weighted average bond yield rose by 341 bps in 2018 to reach 9.95% at the end of the year, falling from a peak level of 11.23% mid-September 2018. Concurrently, the weighted average bid Z-spread expanded by 300 bps to reach 764 bps amid increases in US Treasuries yields after the US Federal Reserve raised its benchmark interest rate four times over the year 2018. Finally, regarding the cost of insuring debt, Lebanon's five-year CDS spreads, which are a measure of market's perception of sovereign risk at large, expanded significantly by 249 bps in 2018 to reach 770 bps at end-December, noting that it has crossed above the 800 bps threshold several times during the second half of the year amid cabinet formation uncertainties. This followed a smaller expansion CDS spreads of 43 bps in 2017.

In parallel, the Beirut Stock Exchange, which suffers from a lack of liquidity and efficiency, dived in the red in 2018 despite luring market valuations, mainly weighed down by rising concerns over an extended domestic political stalemate that could have negative repercussions on Lebanon's economic outlook. 18 out of 27 listed stocks registered price drops ranging between 2.2% and 31.1%, while four stocks posted price gains of 0.9% to 20.8%, and five stocks saw no price change in 2018. This was reflected by a 14.6% plunge in the BSE price index to close at 83.87 at end-December 2018, although Lebanese equities traded at a P/E of 5.2 times in 2018 as compared to a much higher P/E of 14.0 times in the MENA region. Double-digit price falls were accompanied by increased price volatility on the BSE, as the latter, measured by the ratio of the standard deviation in prices to the mean of prices reached 7.1% in 2018, versus 4.0% in 2017.

The Beirut Stock Exchange was also underpinned by reduced activity in 2018. The total turnover contracted by 38.1% year-on-year, moving from US$ 608 million in 2017 to US$ 376 million in 2018. Banking shares captured 63.4% of total activity in 2018, followed by Solidere shares with 29.4% and the industrial & trading shares with 7.2%. Amid significant price drops and due to the listing of BLC Preferred "E" shares and an additional listing of BOB "listed" shares, the BSE market capitalization fell by 13.8% year-on-year to reach US$ 9,117 million at end-2018. Accordingly, the BSE total turnover ratio, measured by the annual trading value to market capitalization, reached 4.1% in 2018 as compared to 5.8% in 2017, remaining way behind regional, emerging markets and global turnover ratios.

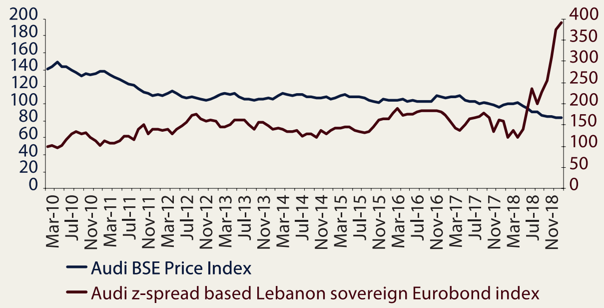
Looking forward, in the aim of developing the capital markets in Lebanon and creating the kind of vigor that would boost economic growth and create jobs, the Capital Markets Authority (CMA) launched in December 2018 a Request For Proposal (RFP) for a tender to select an operator for its planned electronic trading platform (ETP). The RFP aims to create an ETP that would improve financing for private sector

FINANCIAL SECTOR (NON-BANKS)

	2013	2014	2015	2016	2017	2018
Beirut Stock Exchange						
Market capitalization (in millions of US$)	10,057	10,550	10,496	10,951	10,578	9,117
Total trading volume (in millions of US$)	345	619	498	885	608	376
Annual trading volume/Market cap.	3.4%	5.9%	4.7%	8.1%	5.8%	4.1%
Price index	105.3	105.9	104.6	106.9	98.2	83.9
% change in index	-3.1%	0.6%	-1.2%	2.1%	-8.1%	-14.6%
P/E ratio*	7.66	7.16	6.72	6.44	6.38	5.18
P/NAV ratio*	1.07	0.98	0.93	0.91	0.86	0.69
Lebanese Eurobonds						
Total volume (in millions of US$)	24,277	24,252	25,535	26,123	26,123	30,964
Average yield	4.5%	5.5%	6.1%	6.5%	6.5%	10.0%
Average life (in number of years)	5.4	5.0	6.1	6.2	6.7	7.8
5-year CDS spreads variation (bps)	-57	3	26	57	43	249

* For large listed banks

CAPITAL MARKETS PERFORMANCE



activities, especially for small and medium size enterprises as well as startups, and expand trading activities beyond the Lebanese borders with a view to reach the Lebanese diaspora around the world.

2. CONCLUSION: A BRIEF 2018 REVIEW AND 2019 OUTLOOK

In sum, the year 2018 has been a difficult year for the Lebanese economy, sectors of activity and financial markets at large, under growing political uncertainties especially during the second half-year. The year has witnessed a low real GDP growth that the IMF estimates at 1%, bearing in mind that the Lebanese economy needs to grow at no less than 6% to ensure the needed job creation to the 30,000 Lebanese that are joining the Labor force every year. The BDL coincident indicator, a gauge of real sector activity, grew over the first 11 months of 2018 at third its growth in the same period of the past 5 years. The evolution of real sector indicators suggests that almost all economic sectors witnessed additional weaknesses last year. As to the financial sector, financial inflows reported a net contraction last year, weighing on deposit growth, which though still positive, reported a relatively modest performance on the overall.

The growing political uncertainty over the past year, of which the delay in cabinet formation, impacted economic conditions through a number of channels: (1) Adverse effects on private investment driven by the postponement of investor decisions amid growing cloudiness; (2) Adverse effects on public investment on infrastructure through the non-materialisation of CEDRE pledges and the ensuing risks of losing them; (3) Adverse effects on the awaited fiscal reforms to curb down Lebanon's elevated debt and deficit ratios; (4) Adverse effects on capital inflows that are highly needed to finance the country's external deficits. While the above factors are quite meaningful, the real economy, which slowed down further over the past few months, did not yet fall in a recessionary trap as witnessed by a persistently positive though low growth rate. This is actually tied to the quasi-resilience of private consumption, the continuing support of the large Lebanese diasporas and the stable domestic security conditions amid a broad region characterized by large security drifts.

Our macro forecasts for 2019 are based on a 2.5% real GDP growth forecast (a 6% nominal growth) following the recent successful Cabinet formation, and based on a slow progress in CEDRE reforms and implementation. Nominal growth would be driven by: (1) a 6.5% domestically driven growth in private consumption; (2) while private investment is likely to stagnate at its 2018 level amid politico-economic uncertainties weighing on private investors initiatives; (3) a double-digit growth in public investment from a relatively low base within the context of the State's new Capital Investment Program; (4) along with a 14% growth in exports on the basis of the recent reopening of Syrian/Jordanian routes for Lebanese land exports (mainly the Nassib border gate). In parallel, Money Supply would grow by 4% on the back of an 8% growth in financial inflows that would somewhat reduce the balance of payments deficit.

While we do not foresee financial instability in the months ahead on the back of strong monetary and financial buffers related to large FX reserves (standing at 80% of domestic currency money supply) and abundant bank liquidity (standing at 50% of FX deposits), the most significant challenge to face the Lebanese government is to address the public finance imbalances that represent today the most significant vulnerability for the Lebanese economy. At a public debt ratio of 150% of GDP (third highest worldwide) and a fiscal deficit ratio of 10% of GDP (ranging in the Top decile globally), adjustment reforms are now highly needed to ensure a soft-landing of the Lebanese economy. Those include spending rationalization through severe austerity measures, raising domestic resource mobilization, improving tax collection and fighting evasion, reforming the electricity sector along with a series of growth-oriented measures that aim at improving the overall business environment in Lebanon.

While exits still do exist and require tough economic choices on behalf of policy makers, Lebanon does not have anymore the luxury of delaying the long awaited adjustment refoms. Having said that, a tangible advancement at those levels, along with the thorough implementation of the CEDRE pledges to finance infrastructural spending, can create a positive catalyst that would move Lebanon from an era of widening macro uncertainties to an era of gradual containment of risks and threats as a prerequisite to the hoped for economic recovery and the corollary re-alignment of growth with its long term potential.

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