BYBLOS BANK

THE LEBANESE ECONOMY IN 2018

BYBLOS BANK ECONOMIC RESEARCH
AND ANALYSIS DEPARTMENT

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ECONOMIC POLICY

The year 2018 started with cautious optimism about the prospects of the Lebanese economy, given ongoing preparations for three international conferences to support Lebanon, as well as for the long-delayed parliamentary elections scheduled for May 2018. The Rome conference (March 2018) aimed to support the Lebanese Army; the Conférence économique pour le développement, par les réformes et avec les entreprises (CEDRE) in Paris intended to support the economy; and the Brussels conference (May 2018) focused on helping Lebanon to cope with the presence of a large number of Syrian refugees.

In parallel, there was little political appetite for genuine reforms in the months leading to the parliamentary elections of May 2018. But the appetite was evident for policies that serve the electoral interests of most political parties. As such, the hastily planned and inadequately tested across-the-board tax hikes on one hand, and the massive increase in the wages and salaries of public sector workers and employees on the other hand, combined to shape the financial, fiscal and economic landscape of 2018. The impact of these policies, which the government and Parliament rushed to enact in late 2017, quickly materialized and started to take its toll on economic activity in 2018, in sharp contrast to the rosy picture that political parties provided as a justification for these measures.

CEDRE, which took place on April 6, 2018, yielded some US$ 11.2 billion in pledges from the international community in order to finance infrastructure projects that the Lebanese government compiled in its US$ 22.9 billion Capital Investment Program. The disbursement of the pledged funds is contingent on the implementation of the reforms agenda that Lebanon submitted at the CEDRE conference, which include narrowing the fiscal deficit by 1% of GDP per year over five years, among other sectoral and structural reforms.

The main events that improved sentiment in the country during the year were the successful holding of the parliamentary elections, followed by the swift designation of Prime Minister Saad Hariri to form a new government. The elections represented the first opportunity in nine years for Lebanese citizens to exercise their constitutional right to choose their representatives in Parliament, which gave them a sense of empowerment and fueled expectations for better governance at the national level.

But the post-elections euphoria gradually faded in the second half of 2018, due to long delays in the formation of a new government and the challenging economic conditions. Also, the implementation of tax increases on consumption, income, profits and capital gains, as well as the hike in fees on a large number of administrative transactions (all of which Parliament enacted in October 2017 and that went into effect at the start of 2018), took their toll on consumption and investment patterns throughout the year. The tax increases led to a massive redistribution of income from the private sector and households to the bloated and inefficient public sector, which contributed to liquidity shortages in the economy, while the inflationary pressures that persisted throughout 2018 reduced households' purchasing power. This, combined with the uncertainties related to the government's formation, weighed on household and investor sentiment, and on overall economic activity. Moreover, the massive fiscal expansion from the salary scale increase forced Banque du Liban (BDL) to adopt a tight monetary policy, which affected demand for loans and, therefore, business activity.

Political bickering and the constitutional restrictions on the post-elections caretaker government paralyzed policy-making in the country and further weighed on the economy. The resulting delays in reforms led not only to opportunity costs for Lebanon, especially in terms of unlocking the CEDRE-related funds, but also exacerbated risk perceptions about the country at a time when emerging markets were facing an unfavorable external financing environment. In fact, the U.S. Federal Reserve increased its interest rates four times in 2018, and it signaled after its April decision that it intends to increase rates at a faster pace, which led to the strengthening of the US dollar globally and triggered capital outflows from emerging markets, including from the Middle East and North Africa. In turn, this led to increases in interest rates in the region, thereby putting upward pressure on rates in Lebanon. In fact, seven Arab countries other than Lebanon have their currency pegged to the US dollar and most of them immediately adjusted their local rates to the new U.S. rates.

However, BDL took measures to sustain capital inflows to the country, which, in cooperation with commercial banks, successfully weathered the challenges throughout 2018. In addition, various politicians used the prevailing financial and economic conditions in the country as bargaining chips in their protracted negotiations for the formation of the new government. This helped trigger rumors that started to circulate since the beginning of the summer, mostly about purportedly the impending collapse of the Lebanese economy and the national currency, which generated concerns, but not panic, among citizens.

The confluence of domestic and external developments resulted in a re-pricing of Lebanese financial assets, as the stock market index declined by 25% and the Eurobonds price index regressed by 12% for the year; while real estate, which has been traditionally a store of value, continued to turn into a buyers' market.

In parallel, the recruitment of at least 5,200 persons across public agencies in 2018, following the hiring of about 26,000 individuals in the 2014-2017 period, and the swelling of public expenditures from the costly salary scale increase, produced a bloated and unaffordable public sector that turned into an increasing burden on the Lebanese economy in 2018.

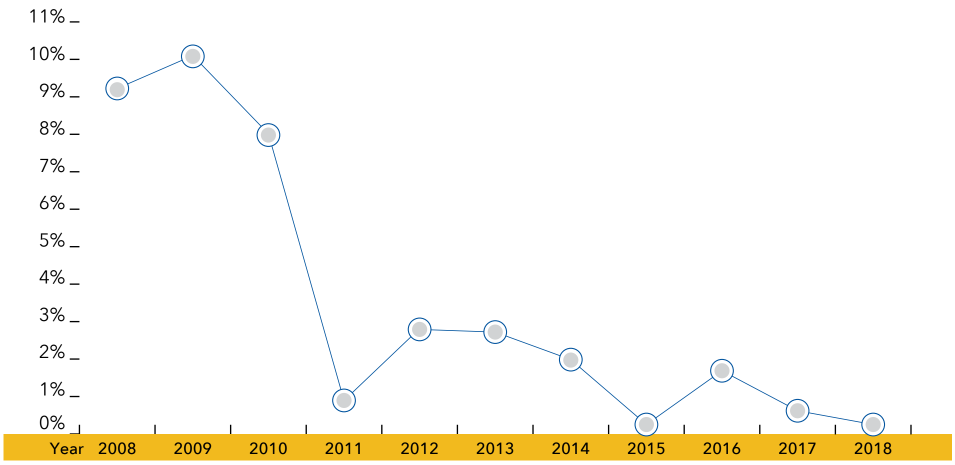
In addition, the Lebanese economy continued to suffer from an inadequate level of competitiveness, a poor investment climate and a weak business environment. The World Economic Forum's 2018 Global Competitiveness Index shows that 56% of ranked countries worldwide and 57% of ranked Arab countries have a more competitive economy than Lebanon does. Also, the World Bank Group's Doing Business 2019 survey indicates that 74% of countries around the world and 60% of Arab economies have a better business climate than Lebanon. In addition, the World Bank's World Governance Indicators for 2018 show that 76% of countries and territories around the world implement their laws better than Lebanon does and 74% of them have a more effective government, while the quality of regulations in 62% of countries worldwide is better than in Lebanon. As a result of the challenging operating environment, Greenfield foreign direct investments, which cover cross-border new projects that lead to the direct creation of jobs and capital investment, were equivalent to just 0.3% of GDP in 2018 relative to 0.1% of GDP in 2017.

In spite of the evolving external financing environment and the politically-induced domestic conditions, the Lebanese economy proved to be particularly adept at absorbing and limiting the impact of such developments throughout the year. As such, BDL, in cooperation with commercial banks, managed to maintain monetary and financial stability in the country. But the loose fiscal policy, the inadequate business climate, and the political paralysis took their toll on economic activity.

Moreover, the weak statistical base in the country continued to limit the transparency of the economy. Throughout the year, and in the absence of official quarterly growth figures or periodic national accounts, global investment banks and international institutions repeatedly revised downward their projections for Lebanon's 2018 economic growth rate from about 2% at the beginning of the year to nearly 0.4% as the year progressed, compared to an official growth rate of 0.6% in 2017. This subdued growth rate came despite a US$ 1 billion stimulus package from BDL for the year, steady remittance inflows of US$ 6.94 billion, a successful tourism season, and US$ 17.8 billion in public spending in 2018.

In parallel, the presence of more than one million Syrian refugees in Lebanon exacerbated the pressure on the country's infrastructure, although this alone did not justify the deterioration in the quality of public-service delivery throughout the year. Further, the amount of disbursed grants related directly or indirectly to Syrian refugees in Lebanon totaled US$ 1.4 billion in 2018, equivalent to 2.5% of GDP, according to the United Nations' financial tracking service. Most of the grants were earmarked towards food security, education, basic assistance, social protection, healthcare, the water sector, shelter, and the energy sector. Also, spending by Syrian refugees in Lebanon averaged US$ 111 per month in 2018, up by 13.4% from US$ 99 in 2017, based on the United Nations' 2018 Vulnerability Assessment for Syrian Refugees in Lebanon.

REAL GDP GROWTH IN LEBANON (%)



Source: National Accounts, Institute of International Finance, Byblos Research

ECONOMIC ACTIVITY

Household sentiment is a key indicator of trends in economic activity in Lebanon, given that private expenditures represent about 87.5% of overall spending in the economy. The Byblos Bank/AUB Consumer Confidence Index averaged 71.4 in 2018, increasing by 22.4% from 58.4 in 2017 and constituting the fifth annual expansion since 2010. However, the increase of the Index came from a low base, as the outcome for 2017 was the seventh lowest since the Index's inception in July 2007. Further, most of the Index's rise in 2018 occurred during the second quarter of the year, driven by the holding of parliamentary elections and the swift nomination of Mr. Hariri to form a new government, which both took place in May 2018. In fact, the Index regressed in eight out of 12 months during the year, as it declined by 1.6% in the first quarter of 2018, rose by 22% in the second quarter, grew by 1.5% in the third quarter, and was almost unchanged in the fourth quarter of 2018.

The results of the parliamentary elections raised the expectations of Lebanese households that the new Parliament and, by extension, the new government, would take measures that would improve their quality of living and economic well-being.

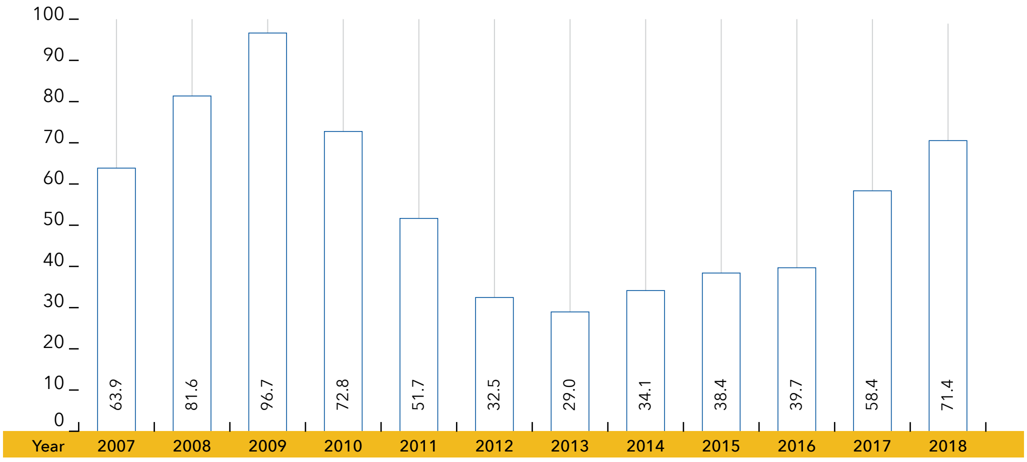
However, the lengthy delays, procrastination and obstacles in the formation of a new Cabinet, along with the rising cost of living, worsening economic conditions, and elevated inflation rates, led to the stagnation of consumer sentiment during the third and fourth quarters of the year, which sapped any momentum in confidence generated by the elections.

Further, the Byblos Bank/AUB Expectations Index posted higher values than the Present Situation Index in each month of 2018. The spread between the two indices was narrow in the first four months of the year, but it widened significantly in May 2018 as a reflection of the impact of the parliamentary elections on citizens' expectations. The spread then narrowed sharply in June as the post-elections euphoria subsided. Even though consumers were more optimistic about their future conditions than their current situation throughout the year, the fluctuations of the spreads reflected consumers' high skepticism about the future.

In parallel, the BDL's Coincident Indicator, a proxy for overall economic activity in Lebanon, increased by 0.6% in 2018, which reflects slow economic activity amid a high inflationary environment. In addition, the BLOM Lebanon Purchasing Managers' Index (PMI), a measure of the performance of the private sector, regressed by 0.7% in 2018. Lebanon's PMI fluctuated between a high of 47.3 in February 2018 and a low of 45.4 in July 2018, but it remained below the 50-point mark, which means that business conditions in the Lebanese private sector continued to deteriorate during the year.

Overall, the Lebanese economy grew below its potential in 2018. The wide gap between the actual real GDP growth rate of 0.4% in 2018 and the potential growth rate, estimated at 3.5% for the year, resulted in output losses of US$ 8.7 billion in 2018. This means that if the economy achieved its potential growth last year, nominal GDP would have reached US$ 64.8 billion in 2018 instead of the actual US$ 56.2 billion.

BYBLOS BANK/AUB CONSUMER CONFIDENCE INDEX



Source: Byblos Bank Economic Research and Analysis Department

CONSUMER CONFIDENCE AND ECONOMIC GROWTH

The fluctuations of the Byblos Bank/AUB Consumer Confidence Index have generally reflected trends in economic growth. More precisely, real GDP growth rates have been correlated historically to the levels of consumer sentiment, because households account for about 87% of private consumption in Lebanon. However, the double-digit increase of the Index in 2018 has not resulted in improved economic activity last year for multiple reasons.

First, the extended government vacuum, which was accompanied by a flood of rumors about the impending collapse of the economy and of the national currency, affected consumer behavior, even though it did not create panic among citizens. As such, households postponed non-essential spending as they awaited clearer political and economic skies, a decision that was reflected by the results of the Index's monthly survey about their outlook towards their personal finances and the business environment in the country.

Second, the already-stretched budgets of households accelerated their decision, as the authorities' ill-conceived increase in taxes on consumption, income, profits and capital gains, which went into effect at the start of 2018, led to a massive redistribution of income from the productive private sector and from households to the bloated public sector.

Third, the tax increases contributed significantly to a shortage of liquidity in the local market at the retail and wholesale levels that triggered cash flow problems for companies in most sectors, leading firms of all sizes to postpone expansion plans or suspend new projects, and for corporates to shift into cost cutting mode.

Fourth, the economy and the private sector were already suffering from high operating costs, due to the expanding size and inefficiencies of the public-sector bureaucracy and its increasing burden on the private sector, as well as due to the low level of economic competitiveness, the deteriorating investment climate, the inadequate infrastructure and the weak business environment. As such, the increase in taxes in a low growth environment exacerbated the operating costs on firms and contributed directly to the slowdown in economic activity in 2018.

Fifth, the massive increase of the public sector's wages, salaries and benefits did not produce the much-hyped positive impact on domestic consumption, as proclaimed by the advocates of this decision back in 2017. In fact, anecdotal evidence suggests that part of the increase benefited the economies of several Middle Eastern and European countries, as many recipients of this salary raise used part of their newfound disposable income and purchasing power to take vacations abroad, rather than spending their money domestically. Specifically, tourism spending abroad by Lebanese citizens amounted to US$ 6.25 billion in 2018, up by US$ 667.7 million or 12% from US$ 5.6 billion in 2017, and posting its highest level during the 2002-18 period. In comparison, tourism spending abroad by Lebanese citizens averaged US$ 4 billion between 2002 and 2017 and US$ 4.8 billion during the 2010-2017 period.

Sixth, the increase of the value-added tax and the raise in the wages and salaries of public sector workers combined to push the inflation rate in 2018 to its highest level since 2012, thereby reducing the purchasing power of households.

Seventh, the widening discrepancy in the confidence levels of public sector workers on one hand, and of private sector employees and the self-employed on the other hand, shows the negative impact of the public-sector wage decision on economic activity. In fact, a particular segment of society benefited at the expense of the larger segments of the society, especially that the latters constitute the engine of economic activity in the country. Indeed, the confidence levels of private sector employees and the self-employed have consistently exceeded the confidence level of public sector workers since the Index's inception, a necessity for consumption and economic activity. However, public sector employees posted throughout 2018, and for the first time, not only a higher but also a much wider confidence level than their private sector counterparts.

The survey's results show that the confidence level of public sector workers increased by 22.5% in 2018, in sharp contrast to a drop of 2.4% in the confidence of private sector employees during the year. This was accompanied by a gap between the two categories that worsened during the year, as the confidence level of public sector workers was 17% higher than that of private sector employees in the first quarter of the year, but it widened to 49% in the second quarter, to 37% in the third quarter, and to 29% in the fourth quarter. Moreover, the confidence level of public sector workers was 10% higher than the confidence level of the self-employed in the first half of 2018, but it widened to 21% in the second half of the year. This new trend in consumer sentiment backfired on consumption and investment in 2018, with direct consequences on economic activity.

Eighth, as a result of all the above factors, we estimate that real GDP grew by a modest 0.4% in 2018, despite the increase of the Byblos Bank/AUB Consumers Confidence Index by 22.4% during the year. This was not the first such instance since the Index's inception, as the Index increased by 47.1% in 2017 from a low base, but real GDP grew by a modest 0.6% during the year. In turn, this points to a more significant trend, which is the decline in the potential growth of the Lebanese economy and the need for deep structural reforms to restore this potential to its previous levels. In addition, reforms have become more urgent in order to avoid the new normal of very low growth rates despite increases in consumer confidence.

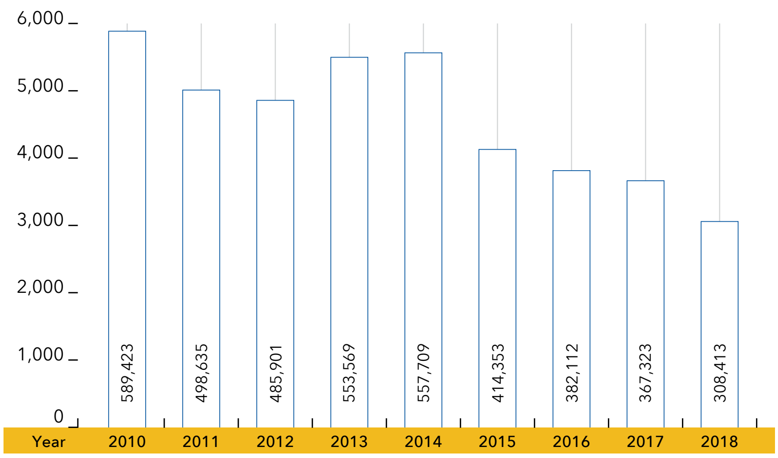
AGRICULTURE

The agricultural sector was affected throughout 2018 by high operating costs, an inadequate infrastructure, the smuggling of agricultural products, dumping from some countries in the region, and by persistent violations of the agricultural calendar for exports to Lebanon, as well as by the fact that a significant part of the sector operates in the informal economy. As a result, the contribution of the sector to economic output has gradually regressed from 2.5% in 2011 to about 1.6% in 2017, according to the latest available national accounts. However, when measuring activity by constant 2010 prices, the sector's activity expanded by 15% in 2017 following a growth of 5% in 2016 and a contraction of 19% in 2015.

Agricultural exports, which mostly include trees, vegetables, fruit, nuts and cereals, totaled 308,413 tons in 2018, down by 16% from 367,323 tons in 2017, and constituting the lowest exported volume since the onset of the Syrian conflict in March 2011. The drop in the volume of exported agricultural products in 2018 is due to a year-on-year decrease of 39% in vegetable exports and to decline of 8% in the export of cereals. Overall, the volume of agricultural exports decreased by 45% between 2014 and 2018. Agricultural exports accounted for 16.8% of total exports in 2018, down from 19% in 2017 and 25% in 2014.

The closure in April 2015 of the Jaber-Naseeb crossing point on the Syrian-Jordanian border, which was the only remaining open land route at the time for the transport of goods from Lebanon and Syria to Jordan, Iraq and Gulf Cooperation Council (GCC) countries, negatively affected overall exports, including agricultural products. The reopening of the Jaber-Naseeb crossing point on October 15, 2018 had a limited impact on agricultural exports during the remainder of 2018 mostly due to the increase by five-fold of the transit tariffs at the crossing point.

EXPORTS OF AGRICULTURAL PRODUCTS (tons)



Source: Lebanese Customs, Byblos Research

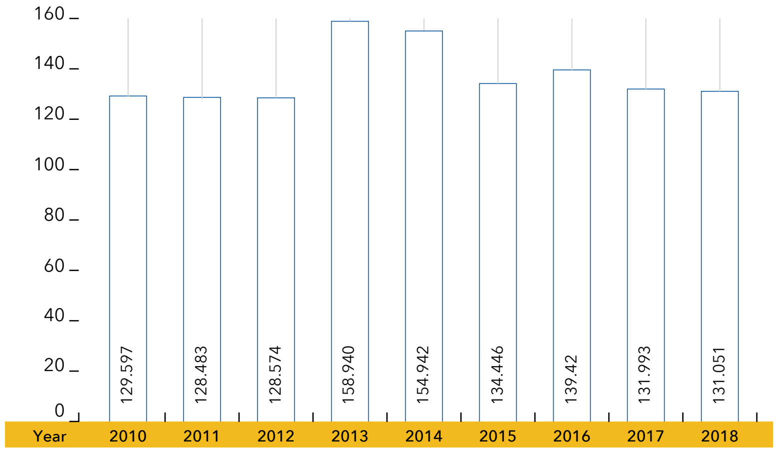
Lebanon's agricultural exports continued to suffer in 2018 despite some government measures to facilitate and promote export activity. The Lebanese government launched the Agri Plus subsidy program in January 2012 with the aim to develop agricultural exports by providing financial incentives to exporters and farmers in the country. The program, which is administered by the Investment Development Authority of Lebanon, covered fruits, vegetables, olive oil, eggs, as well as flowers and plants. However, the closure of the Jaber-Naseeb crossing point was a setback for the program. In response, the government started subsidizing in August 2015 the additional cost of maritime exports of Lebanese agricultural and industrial products to Arab countries through the Maritime Lebanese Exports Bridge (M.LEB) program. The M.LEB covers part of the additional costs that Lebanese exporters would incur when shipping their products through sea, rather than via traditional land routes. Even though the program, which aims to ensure the flow of Lebanese products specifically to Gulf Cooperation Council countries and Jordan, was operational throughout 2018, agricultural exports suffered from the extra time through the maritime route. Exported products through the Agri Plus subsidy program totaled 277,336 tons in 2018, down by 19.5% from 344,621 tons in 2017, the lowest volume since the start of the program, and compared to a high of 526,782 tons in 2014.

The port of Beirut was the exit point for 60% of agricultural products in 2018, followed by the Port of Tripoli (17%), the Masnaa crossing point (16%), and the Hariri International Airport (5%). In comparison, the Masnaa crossing point was the main exist point for about 60% of agricultural products in 2010 and for 65% of such products in 2014, the year preceding the closure of the Jaber-Naseeb crossing point. Egypt was the recipient of 19% of Lebanon's agricultural exports in 2018, followed by Syria (17%), Kuwait (15%), Saudi Arabia (14%), and the UAE (12%).

In parallel, the amount of agricultural exports totaled US$ 131.1 million in 2018, nearly unchanged from US$ 132 million in 2017, relative to a drop of 5.3% in 2017. In fact, the amount of exported edible vegetables decreased by 29% or US$ 16.4 million in 2018, while the amount of fruits and nuts exported rose by 18% or US$ 11.9 million and the value of oil seeds nearly tripled to US$ 6.1 million last year.

Further, Lebanon's exports of edible vegetables have been declining since 2014, dropping by 68% in terms of volume and by 48% in terms of value. In contrast, the value of exported fruits and nuts has increased by 22% between 2014 and 2018, even though their exported volume dropped by 15%. The prevailing trend shows a shift towards the export of fruits that generate higher revenues.

EXPORTS OF AGRICULTURAL PRODUCTS (US$ million)



Source: Lebanese Customs, Byblos Research

In parallel, utilized bank credit by the agricultural sector reached US$ 789.1 million at the end of 2018, up from US$ 785.2 million at the end of 2017, and accounting for 1.1% of total utilized credits in the Lebanese economy. Also, utilized bank credit by the agricultural sector represented 1.6% of utilized credits when excluding consumer loans, similar to the sector's contribution to economic output, which is 1.6% of GDP. However, the expansion of bank lending to the sector continued to face a major obstacle, which is the informal nature of a large portion of the agricultural sector.

Also, the Kafalat Corporation extended 116 loan guarantees to small- and medium-sized enterprises (SMEs) in agriculture in 2018, down from 210 guarantees in 2017 and from a high of 609 guarantees in 2010. The number of loan guarantees to SMEs in agriculture accounted for 37.4% of total guarantees in 2018, down from 38.8% in 2017 and 43.4% of the total in 2010.

INDUSTRY

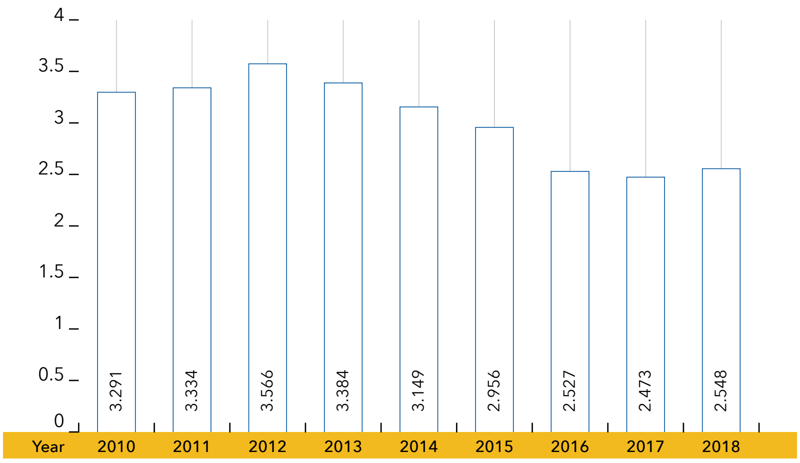
The performance of the industrial sector was subdued in 2018, as it was affected by elevated operating costs, the deteriorating quality of infrastructure, a weak logistics environment, as well as by smuggling, foreign dumping, and illegal and unfair competition from manufacturing operations in the informal economy. Further, the low growth environment in the country affected the sector, given that the domestic market accounts for 82% of the sales of Lebanese manufactured products, according to the Association of Lebanese Industrialists (ALI).

According to the most recent national accounts for Lebanon, the manufacturing sector's contribution to GDP at current prices stood at 8.6% in 2017, unchanged from 2016 and compared to 7.6% in 2010. However, when using constant 2010 prices, the sector's activity regressed by 2.7% in 2017 and by 12.7% between 2010 and 2017, which reflects declining output.

Also, BDL's periodic survey of the opinions of business managers shows that industrial production regressed in the first, second, third and fourth quarters of 2018 compared to the same quarters, respectively, of 2017. Further, registered orders declined in each quarter of 2018 relative to the same quarter of the previous year; while total demand for industrial products decreased year-on-year in all four quarters of 2018. Moreover, the volume of investments in the sector dropped in the first, second, third and fourth quarters of last year. The survey shows that the majority of business managers considered that overall industrial activity sharply deteriorated in the third quarter, but that it stabilized in the fourth quarter of 2018.

Further, the high operating costs and the closure of the Jaber-Naseeb crossing point between Syria and Jordan during the 2015-18 period, took their toll on the exports of manufactured products. Figures released by the Ministry of Industry show that industrial exports totaled US$ 2.6 billion in 2018, up by US$ 74.4 million, or by 3%, from US$ 2.5 billion in 2017, and constituting the first annual increase since 2012. Still, industrial exports were below the annual average of US$ 3.1 billion during the 2010-2017 period. They have declined from their peak of US$ 3.57 billion in 2012 due to the increase in transportation and safety risks in Syria following the eruption of the conflict in that country, given that Syria constitutes the only land outlet for Lebanese exports.

INDUSTRIAL EXPORTS (US$ billion)



Source: Ministry of Industry, Byblos Research

Still, Lebanese industrial exports remained diversified both structurally and geographically, and continued to compete internationally as, according to the ALI, Lebanon exports 337 "highly competitive" products. Exports of chemical products totaled US$ 470.5 million and accounted for 18.5% of aggregate industrial exports in 2018, followed by machinery & mechanical appliances with US$ 449.2 million (17.6%), foodstuffs & tobacco with US$ 398 million (15.6%), base metal exports with US$ 394 million (15.5%), plastics & rubber with US$ 187.4 million (7.4%), pearls or semi-precious stones with US$ 153.7 million (6%), and paper & paperboard with US$ 140.2 million (5.5%).

Further, Arab countries generated the majority of demand for Lebanese manufactured products sold abroad, as they were the destination of 51.3% of Lebanese industrial exports in 2018, followed by European economies with 18%, Asian countries with 12.3%, African economies with 11.4%, countries in the Americas with 5.6%, and markets in Oceania with 0.7%. On a country basis, the UAE was the main destination of Lebanese industrial exports and accounted for 9.6% of the total in 2018, followed by Saudi Arabia with 8.2%, Syria with 8%, Iraq with 6.7%, Turkey with 5.4%, and Qatar with 4.8%. In addition, the economies of the Gulf Cooperation Council continued to be a vital market for Lebanese manufacturing, as they accounted for 25.4% of total industrial exports and for 49.5% of industrial exports to the Arab world in 2018.

The banking sector maintained its support to Lebanese industry, as utilized credit by the manufacturing sector reached US$ 6.45 billion at the end of 2018, up by 11% from US$ 5.81 billion at the end of 2017. The amount of loans to manufacturers accounted for 9.3% of total utilized credits in the Lebanese economy and for 13.3% of utilized credits when excluding consumer loans. As such, lending to the manufacturing sector exceeded the sector's size in the economy, which stands at 8.6% of GDP.

Also, the Kafalat Corporation extended 115 loan guarantees to SMEs in manufacturing in 2018, down from 182 guarantees in 2017 and from a peak of 543 in 2010, reflecting the challenging operating environment. The number of loan guarantees to SMEs in manufacturing accounted for 37.1% of total Kafalat guarantees to all sectors in 2018, up from 33.6% in 2017 and compared to 39% of the total in the peak year of 2010. The drop in the number of loans guaranteed by Kafalat is mainly due to higher lending rates and to the banks' reduced appetite to extend such loans, amid the higher cost of funds and the rising number of clients who are facing challenges to repay their loans. Also, demand for Kafalat loans has decreased due to the challenging operating environment in the country.

TRANSPORTATION

The car sector in Lebanon faced significant challenges in 2018, which include a slowdown in economic activity, and the 10% effective increase in the value-added tax rate that came into effect at the beginning of the year. In addition, the rise in domestic interest rates in 2018 has increased the cost of car loans, which weighed on car demand in the country.

More importantly, the car sector continues to suffer from elevated customs and value-added taxes, as well as from high registration and mécanique fees. According to Lebanese customs, the custom tax on imported used cars valued at LBP 20 million is LBP 500,000, the excise tax is LBP 4.5 million and the VAT is LBP 2.75 million. As such, the aggregate amount of taxes on such vehicles, excluding registration fees, is LBP 7.75 million or 39% of the car value.

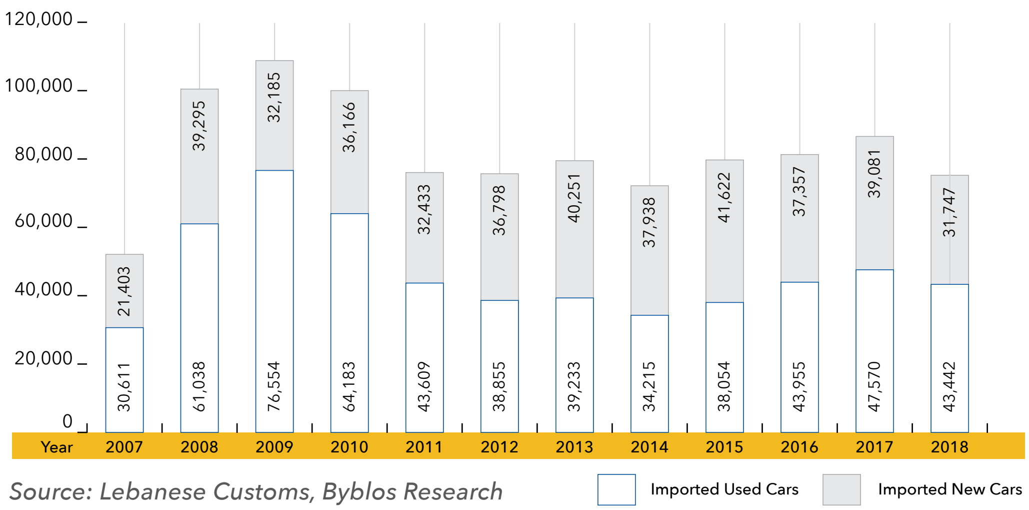
According to the most recent national accounts for Lebanon, the transportation sector, which includes road, air and other transport means, contributed 3.2% to GDP at current prices in 2017, nearly unchanged from 2016 and compared to a high of 3.9% in 2008. The sector's contribution to GDP during the 2010-17 period has ranged between a low of 3% in 2012 and a high of 3.4% in 2015. When using constant 2010 prices, the growth rate in the sector's activity decelerated from 9.4% in 2015 to 5.9% in 2016 and 2.7% in 2017. In parallel, utilized bank credit for the purchase of cars in Lebanon reached US$ 1 billion at the end of 2018 compared to US$ 1.18 billion at the end of 2017, and accounted for 4.7% of utilized consumer loans and for 12.1% of consumer loans, excluding housing loans, at the end of 2018.

Despite the prevailing conditions, consumers' intentions to buy cars in Lebanon increased in 2018. Byblos Bank has been collecting data about Lebanese consumers' plans to purchase new or old cars since July 2007 through the monthly Byblos Bank Consumer Confidence Survey. The survey's results show that, on average, 7.3% of resident Lebanese citizens polled in 2018 had plans to purchase a car over the coming six months, compared to an average of 5.8% in 2017. The increase in the share of consumers who had plans to purchase a car in 2018 comes from a low base, as the 2017 outcome was the lowest since we started collecting data in July 2007. Also, the increase was mostly due to the May 2018 elections and the swift nomination of Prime Minister Hariri, which raised the expectations of potential car buyers that conditions to proceed with actual car purchases will improve. In fact, 10.4% of Lebanese consumers polled in June

2018 had plans to purchase a car over the coming six months, the highest level since October 2011. This share gradually decreased to 6.5% in October 2018, before ticking up to 8.5% by the end of the year. On a quarterly basis, 5.9% of resident Lebanese citizens in the first quarter of 2018 had plans to purchase a car in the following six months, compared to an average of 7.8% in the second quarter, 8% in the third quarter and 7.5% in the fourth quarter of the year. Overall, the share of consumers who had plans to purchase a car in 2018 was below the peak level of 15.7% in 2009 and the monthly average of 9.2% between July 2007 and December 2018. As such, 92.7% of respondents surveyed in 2018 did not plan to buy a vehicle in the next six months. In addition, 53% of consumers who had plans to purchase a car in 2018 preferred to buy a new car, while 40% preferred to buy a used car and 7% were undecided at the time of the survey.

Consumers' intentions to buy cars in Lebanon did not translate into actual sales. In fact, Lebanon imported 75,189 passenger cars in 2018, constituting a decrease of 13.2% from 86,651 vehicles in 2017, the lowest level since 2014. It imported 43,442 used cars in 2018, down by 8.7% from 2017, while it imported 31,747 new passenger cars in 2018, reflecting a decline of 18.8% year-on-year. Used cars accounted for 58% of total car imports in 2018, while new cars represented the balance of 42%.

EVOLUTION OF NUMBER OF IMPORTED CARS



Source: Lebanese Customs, Byblos Research

In parallel, car dealers in Lebanon sold 33,012 new passenger cars in 2018, constituting a decline of 11.3% from 37,222 cars sold in 2017, the first double-digit contraction in new car sales since 2005. The breakdown of new car sales in 2018 shows that the private sector purchased 27,788 vehicles or 84% of the total and rental companies bought 4,581 cars (14%), while the public sector, including the government, public institutions and security forces, acquired 643 cars (2%). Cars purchased by the public sector declined by 10.2% in 2018 and vehicles bought by rental companies contracted by 17%, while cars acquired by the public sector decreased by 17.2% year-on-year.

There are 59 different passenger car brands available for sale in Lebanon from China, Europe, Japan, South Korea and the United States. Japanese cars have led the Lebanese automobile market since 2015, when they overtook Korean cars that dominated the market between 2011 and 2014. Japanese cars accounted for 40.7% of total new car sales in 2018, followed by Korean vehicles with a 28.3% share, European automobiles (19.5%), American cars (8.6%), and Chinese vehicles (2.9%). Demand for Korean vehicles dropped by 25.8% in 2018, the sales of European automobiles decreased by 13.5%, the number of American cars sold declined by 4.2%, and demand for Japanese automobiles regressed by 2.1% year-on-year in 2018. In contrast, the sales of new Chinese vehicles surged by 92.8% during the year.

Consumers have shown preference for buying small-engine cars in recent years and this trend continued in 2018. In fact, the market share of smaller-engine cars has remained stable at around 90% of new vehicles sold since 2011. The sustained demand for smaller-engine cars is mainly due to the high demand for fuel-efficient cars, lower overall car prices that entail relatively lower tariffs than large engine vehicles, as well as due to lower taxes, registration fees and mécanique fees. Other factors that supported this trend include the lower cost of maintenance and spare parts for smaller-engine cars than for larger ones.

In parallel, the Ministry of Environment announced new incentives to promote eco-friendly cars as part of the 2018 Budget Law that the Lebanese Parliament enacted in March 2018. The law reduced customs and excise taxes on hybrid cars to 20%, while it exempted electric vehicles from all customs and excise taxes. Also, the law lowered customs and excise taxes on hybrid vehicles for public use, such as hybrid taxis, to 10%, and fully exempted electric vehicles for public use from customs and excise taxes. In addition, the law exempted public hybrid cars and electric vehicles from registration fees and mécanique fees when registered for the first time. But this new segment of the vehicles market has not generated material demand and has yet to compete with regular cars.

INSURANCE

The Lebanese insurance sector, similar to other sectors in the economy, was affected by the challenging operating environment in the country during the year. As such, figures released by the Insurance Control Commission (ICC) show that the gross written premiums of 50 licensed insurance companies in Lebanon reached US$ 1.64 billion in 2018, nearly unchanged from US$ 1.63 billion in 2017 and compared to a rise of 3.9% in 2017. The growth in insurance premiums has been in the low single-digits since 2014, following double-digit annual growth rates in premiums in almost every year between 2002 and 2010.

Premiums generated in 2018 consisted of net premiums that expanded by 1.3% to US$ 1.3 billion, policy fees that declined by 4% to US$ 242 million, and the cost of policies that reached US$ 110.4 million in 2018 compared to US$ 111.8 million in 2017. After adjusting for inflation, insurance premiums in the country regressed by 1.3% in real terms in 2018, similar to the contraction rate in 2017.

The increase in taxes on consumption, income and profits, slowing activity in many sectors, the stagnation in household confidence, a decline in the disposable income and purchasing power of individuals, higher inflation, and almost non-existent Greenfield foreign direct investments, affected the insurance sector throughout 2018.

Non-life premiums reached US$ 1.12 billion and accounted for 68.2% of the sector's aggregate premiums in 2018, while life insurance premiums totaled US$ 520.4 million in 2018 and represented 31.8% of the total. Non-life premiums regressed by 1.4% and life premiums grew by 3.7% year-on-year.

Medical insurance premiums totaled US$ 504 million and accounted for 46.6% of non-life premiums generated in 2018, followed by the motor insurance line with US$ 351.5 million (31.5%), fire insurance with US$ 104.6 million (9.4%), the accidents insurance line with US $67 million (6%), and the transportation category at US$ 35.2 million (3.2%), while written premiums for the other non-life segments totaled US$ 53.6 million (4.8%). Further, medical insurance premiums grew by 5.3% in 2018, while accidents insurance premiums dropped by 7.3% year-on-year, motor premiums declined by 7.2%, fire insurance premiums decreased by 4.5% and transportation insurance premiums regressed by 3.3% in 2018.

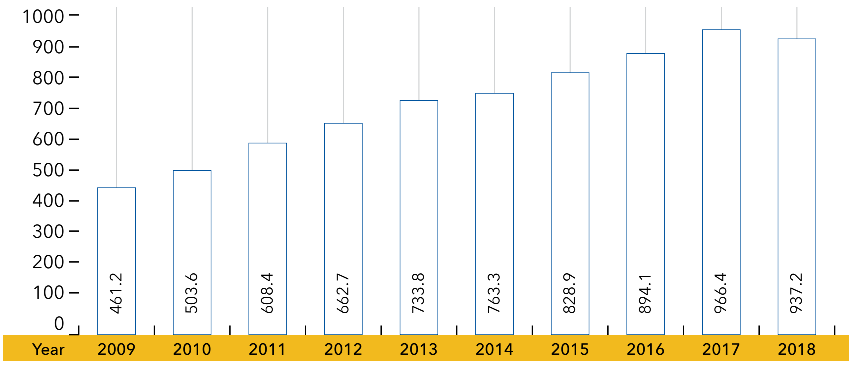
The insurance penetration rate in Lebanon, or premiums relative to the size of the economy, was 2.9% of GDP in 2018 compared 3.1% of GDP in 2017. Lebanon ranked in 44th place among 87 countries worldwide and in second place in the Arab world on this indicator. The life insurance penetration rate reached 0.93% of GDP, ranking Lebanon in 51st globally and in second place in the Arab world, while non-life premiums posted a penetration rate of 1.99% of GDP, which placed Lebanon in 32nd place among 88 countries worldwide and in third place among Arab countries. Lebanon's insurance penetration rates for life, non-life and total premiums were higher than the penetration rates of 0.79% of GDP, 1.2% of GDP and 1.99% of GDP, respectively for the Emerging Europe, the Middle East & Africa region. However, they came lower than the corresponding global penetration rates of 3.31% of GDP, 2.78% of GDP and 6.09% of GDP, respectively.

Further, the insurance density in Lebanon, or premiums per capita, was US$ 335 in 2018, unchanged from 2017. Lebanon ranked in 51st place among 87 countries worldwide and in third place among Arab countries on this indicator. Also, insurance density for the life branch reached US$ 107 in premiums per capita, which ranked Lebanon in 50th place globally and in second place regionally; while the insurance density for the non-life category was US$ 229, which placed Lebanon in 47th place among 88 countries worldwide and in sixth place among 12 Arab countries with available figures in 2018. Lebanon's insurance density rates for life, non-life and total premiums were higher than the corresponding density rates of US$ 34, US$ 51 and US$ 85, respectively, in the Emerging Europe, the Middle East & Africa region. However, they came lower than the global corresponding density rates of US$ 370, US$ 312 and US$ 682, respectively.

Among the active insurance companies in Lebanon in 2018, 29 firms provided life and non-life insurance products, 16 offered non-life insurance and five insurers provided only life insurance products. The sector remained concentrated, as the top five firms in terms of life and non-life premiums accounted for 37.5% of aggregate premiums, while the top 10 firms controlled 65% of the sector's premiums. Also, the top five firms in terms of life premiums accounted for 65.3% of the branch's aggregate premiums, while the top 10 firms controlled for 86.6% of life premiums. Further, the top five firms in terms of non-life premiums accounted for 39.7% of the category's aggregate premiums, while the top 10 firms controlled 65.4% of non-life premiums.

In parallel, gross claims settled by insurance firms stood at US$ 937.2 million in 2018, constituting a decline of 3% from US$ 966.4 million in 2017. Gross claims paid for the medical category amounted to US$ 362.2 million in 2018 and accounted for 38.7% of total claims settled by insurers. Claims disbursed for the life insurance branch followed at US$ 291.5 million (31.1%), then the motor insurance category at US$ 194.8 million (20.8%), fire insurance at US$ 33.1 million (3.5%), the accidents insurance line at US$ 25 million (2.7%), and transportation at US$ 11.7 million (1.2%); while claims paid for other non-life lines totaled US$ 18.6 million, or 2% of aggregate claims paid in 2018. Also, claims disbursed for the life insurance branch declined by 4.2%, while claims paid for the non-life insurance branch decreased by 2.5%.

TOTAL CLAIMS PAID (US$ million)



Source: Insurance Control Commission

Further, the profitability metrics of the insurance sector improved in 2018, as the declared net profits of the 50 licensed insurance companies in Lebanon reached US$ 174.1 million in 2018, constituting an increase of 14.1% from US$ 152.6 million in 2017. Net profits from the life branch accounted for 68% of the sector's net earnings in 2018 relative to 72.2% in 2017, while those from the non-life branch represented 32% of the total compared to 27.8% in the previous year. The sector's net profit margin reached 10.6% in 2018, up from 9.3% in 2017. Further, net investment income totaled US$ 132.6 million in 2018 and was nearly unchanged from the preceding year. The sector's return on assets increased from 3.2% in 2017 to 3.5% in 2018, while its return on equity improved from 13% in 2017 to 14.5% in 2018.

Also, net income from the life category totaled US$ 118.2 million in 2018 and increased by 7.4%, while net profits from the non-life category amounted to US$ 55.9 million and expanded by 31.6% year-on-year. The results of the non-life category show that fire insurance generated net profits of US$ 16.5 million in 2018, followed by the accidents insurance line with US$ 12.5 million, health coverage with US$ 8.4 million, motor insurance with US$ 8.3 million, the transportation line with US$ 4.9 million and civil liability insurance with US$ 2.3 million. The credit insurance and contractors all risk insurance segments posted losses of US$ 0.7 million and US$ 0.4 million, respectively.

In addition, the aggregate loss ratio of the 50 insurance companies, or the ratio of claims incurred to earned gross premiums, was 60.6%; and the commission ratio, or the ratio of acquisition cost to earned gross premiums, reached 17.1% in 2018. Also, the expense ratio, or the ratio of other general expenses to earned gross premiums, was 13.6%; and the reinsurance ratio, or the ratio of net reinsurance income to earned gross premiums, reached 5.1% in 2018. As such, the average technical combined loss ratio, which is the aggregate of the above four ratios, reached 96.3% in 2018 compared to 100.5% in 2017. The average technical combined loss ratio for the life branch regressed to 92.7% in 2018 from 107.4% in 2017, and the corresponding ratio for the non-life branch reached 98% in 2018 compared to 97.2% in 2017.

REAL ESTATE AND CONSTRUCTION

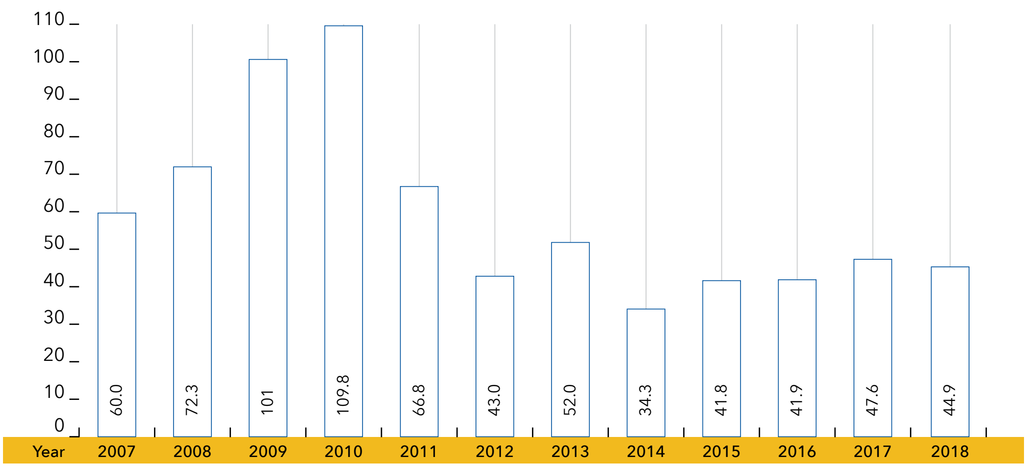
The real estate market, which contributes nearly 15.4% of economic output in Lebanon, was affected by adverse conditions in 2018, including subdued economic activity, political uncertainties, weak consumer confidence, higher interest rates, as well as by the absence of a comprehensive housing policy and the oversupply of residential units.

Moreover, the housing market suffered a setback in 2018 when available funds from BDL to subsidize housing loans dried up early in the year. BDL had to launch two successive stimulus packages for 2018 amid the spike in demand generated from the massive increase in the public sector's wages and salaries. Commercial banks quickly utilized the housing facilities in the first stimulus package for 2018 that BDL launched in October 2017. As a result, BDL announced in January 2018 its second US$ 1 billion stimulus package through which it subsidized interest rates on loans to several sectors, including LBP 750 billion in housing loans. BDL indicated at the time that banks will benefit from this facility on a first-come first-served basis, provided that each bank does not exceed its individual allowance for 2018 that is set by BDL. However, most banks exhausted their individual limits for housing loan subsidies in Lebanese pounds for 2018 shortly after the January stimulus package. Consequently, BDL issued in March 2018 Intermediate Circular 487 that allowed these banks to continue benefiting from the subsidies that BDL pays on housing loans, provided that they cover the cost of the subsidies on the loans in 2018 from their own funds, while BDL pledged to cover the interest subsidies from 2019 onwards. In fact, BDL, in cooperation with commercial banks, had been subsidizing interest rates on housing loans since 2009 to support the residential market, even though such support should come from the government rather than from the banking sector.

As a result, the amount of housing loans outstanding reached US$ 12.89 billion at the end of 2018, equivalent to 22.9% of GDP, compared to US$ 13.02 billion a year earlier, or 24.4% of GDP.

Further, the Byblos Bank Real Estate Demand Index, which reflects the intentions of resident Lebanese to buy or build a home, decreased by 5.7% in 2018. The value of the Index regressed in two out of the four quarters of 2018. In fact, the suspension of subsidized housing loans reduced local demand and negatively affected citizens' home-buying decisions in the first quarter of the year. The Index improved in the second quarter of 2018, mainly due to the announcement in April by the ministries of Finance and of Social Affairs that the government intended to allocate LBP 1,100 billion for subsidized housing loans, which raised expectations that affordable mortgages for limited-income citizens would resume. Also, the increase in the Index in the third quarter of the year followed the Lebanese Parliament's vote in September to allocate LBP 100 billion for similar subsidies, which once again raised expectations that subsidized mortgages would resume. However, the relevant authorities did not make any concrete progress on these initiatives, which weighed on sentiment in the fourth quarter. Overall, the Index's average monthly score in 2018 constituted a decline of 59% from the peak registered in 2010 and was 24.7% lower than the trend average monthly score since the inception of the Index's calculation in July 2007.

BYBLOS BANK REAL ESTATE DEMAND INDEX



Source: Byblos Bank Economic Research and Analysis Department

On the supply side, the surface area of construction permits for buildings decreased by 22% in 2018, according to the Order of Engineer and Architects of Beirut. The surface area of construction permits for new residential buildings regressed by 24% last year, the area for new commercial buildings and offices contracted by 25%, and the surface area for industrial- and agricultural-related buildings decreased by 15%. The three segments accounted for 92.3% of the total surface area of construction permits for new buildings in 2018.

Construction activity in Lebanon continued to be skewed towards the residential sector, with residential buildings accounting for 77% of the surface area of construction permits in 2018. The supply in this segment has been trending towards small-sized residential units since 2012 to adapt to the new market fundamentals. According to a survey conducted by real estate advisory firm RAMCO, the average size per apartment under construction in Beirut was 173 square meters (sqm) in 2018, and declined by 79 sqm between 2013 and 2018. The average size of apartments under construction in the capital city has gradually decreased from 252 sqm in 2013 to 216 sqm in 2015 and 182 sqm in 2017.

Further, the Order of Engineers & Architects of Beirut issued 5,497 authorizations to start construction work in 2018, constituting a decrease of 13% from 6,319 authorizations in 2017 and relative to a decline of 9.5% in 2017. Applications for the authorization of construction permits for new buildings, as well as for modification or extension of buildings and for their restoration, have to be filed during a period of up to one year after receiving the construction permit, depending on the surface area of the project. The surface area of issued authorizations reached 5.86 million sqm in 2018, constituting a decrease of 15.6% from 6.95 million sqm in 2017 and compared to a decline of 12.1% in 2017. The surface area of issued authorizations for new residential units consisted of 3.9 million sqm for residential buildings and 982,676 sqm for individual houses last year, equivalent to 67% and 16.8% of the total, respectively. Commercial buildings & offices followed with 391,258 sqm, or 6.7% of the total, then industrial- and agricultural-related buildings with 258,124 sqm (4.4%), general service buildings such as hospitals and schools with 99,278 sqm (1.7%), general purpose buildings with 40,541 sqm (0.7%), and hotel- and tourism-related buildings with 23,109 sqm (0.4%).

In parallel, the construction sector contributed 3.5% economic output in 2017, according to the latest national accounts, down from 4.1% in 2016 and from a high of 5.9% in 2013. Also, when measuring activity by constant 2010 prices, the sector's activity contracted by 3.8% in 2017, as well as by 7.3% between 2013 and 2017.

Further, utilized bank credit by the construction sector reached US$ 11.16 billion at the end of 2018, down from US$ 11.45 billion at the end of 2017. They accounted for 16% of total utilized credits in the Lebanese economy at the end of 2018 and for 23.1% of such credits when excluding consumer loans. Both shares were significantly higher than the sector's contribution to economic output. Loans to general contractors accounted for 33% of the sector's utilized credits, followed by loans to commercial buildings contractors with nearly 32%, residential contractors with 26% and sub-contractors with 7%, while other contractors accounted for the remaining 2%.

In addition, BDL's periodic survey of the opinions of business managers shows that general construction activity regressed year-on-year in the first, second, third and fourth quarters of 2018. In fact, the balance of opinions about construction activity declined in each quarter of the year relative to the same quarter of the previous year, while the balance of opinions about public works dropped year-on-year in all four quarters of 2018. Moreover, the portfolio of projects in the sector dropped in the first, second, third and fourth quarters of last year, while construction costs were unchanged in the first quarter, rose in the second quarter, dropped in the third quarter and slightly increased in the fourth quarter of 2018.

TOURISM

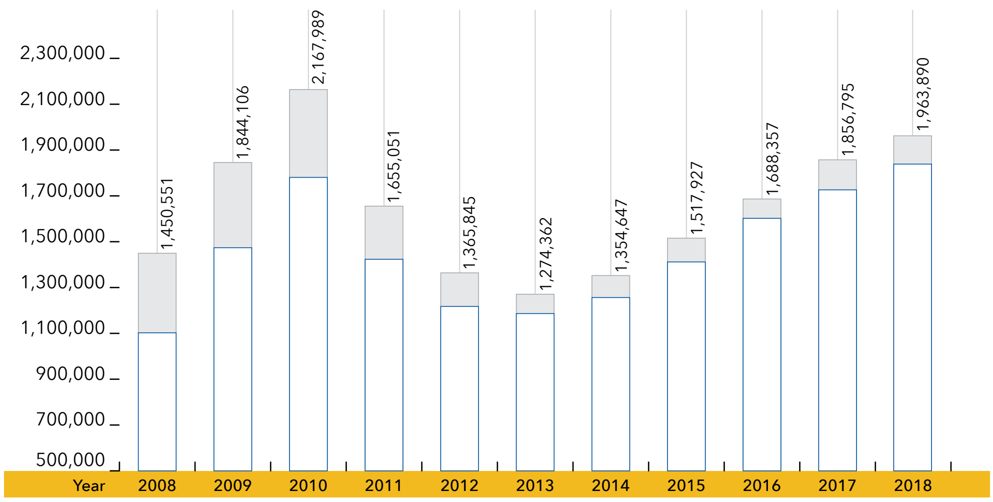
The tourism sector, which used to be a main driver of economic activity in Lebanon prior to 2011, improved slightly in 2018 following initiatives by the Ministry of Tourism and stakeholders in the private sector, which aimed to boost tourist numbers and spending. In addition, the favorable timeline of religious holidays during the summer season, such as Eid al-Fitr in early June and Eid al-Adha in August, along with stable security conditions, supported tourist arrivals in the third quarter of the year. Also, favorable weather conditions helped expand winter-related tourism in the country toward the end of 2018. Further, for the second year in a row, the Ministry of Tourism held in May the Visit Lebanon International Forum, a platform to promote Lebanon as a tourist destination to foreign companies and tour operators in the sector.

The number of incoming visitors to Lebanon totaled 1.96 million in 2018, increasing by 5.8% from 1.86 million in 2017 but constituting a decline of 9.4% from the peak of 2.17 million visitors in 2010. Tourist arrivals in the third quarter of 2018 were the third highest quarterly arrivals during the 2008-2018 period, while arrivals in December 2018 were the highest for that month since December 2008.

The increase in the number of tourist arrivals in 2018 did not significantly alter the composition of visitors from the previous year, as the number of European visitors accounted for 36% of the total and continued to surpass the number of Arab tourists (28.6%). Visitors from the Americas accounted for 18.2% of total tourists in 2018, followed by visitors from Asia (7.2%), Africa (5.5%), and Oceania (4.5%). In fact, most of the increase in the number of tourists is attributed to visitors from European countries and the Americas. The number of visitors from European countries increased by 10.4% in 2018, followed by visitors from the Americas (+9.2%), Oceania (+7.1%), and Asia (+3%), while the number of visitors from the Arab region was nearly unchanged and the number of tourists from Africa regressed by 0.6%.

Further, the number of incoming visitors from Gulf Cooperation Council (GCC) countries reached 128,212 in 2018 and accounted for 6.5% of Lebanon's total tourist arrivals, compared to a share of 6.8% in 2017 and of 17.7% in 2010. The number of incoming visitors from most GCC countries decreased in 2018 from the preceding year, except for the number of visitors from Qatar, which more than doubled from a low base in 2017.

TOURIST ARRIVALS



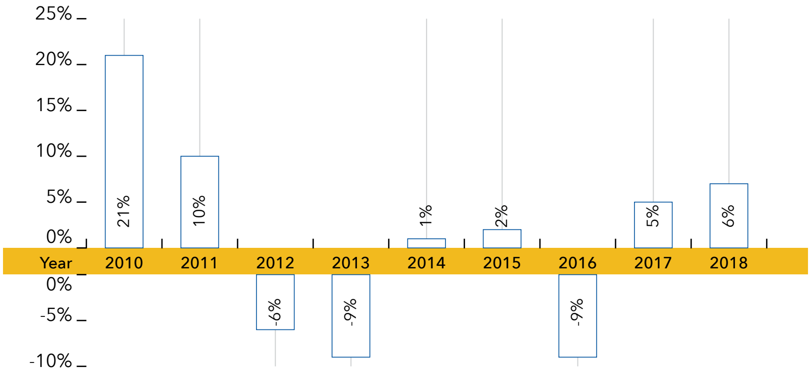
Source: Ministry of Tourism

In parallel, tourist receipts reached US$ 8.4 billion in 2018, constituting an increase of 10.4% from US$ 7.6 billion in 2017, the highest amount on record relative to the previous peak of US$ 8 billion in 2010. They amounted to US$ 1.6 billion in the first quarter of the year, US$ 2 billion in the second quarter, US$ 2.6 billion in the third quarter and US$ 2.2 billion in the fourth quarter of 2018.

Further, the amount of purchases that resulted in value-added tax refunds for visitors grew by 6.5% in 2018 following a rise of 5.5% in 2017. Visitors from Saudi Arabia accounted for 12% of the total amount of purchases in 2018 compared to a share of 14% in 2017. They were followed by visitors from the UAE with a share of 11% relative to 12% in 2017; Syria with 10%; Kuwait with 7%; Qatar with 6%; Egypt with 5%; France, Jordan, and the United States with 4% each; and Canada with 3%. As such, visitors from Saudi Arabia, the UAE and Kuwait accounted for 30% of total purchases in 2018 relative to 43% in 2010. Specifically, visitors from Saudi Arabia accounted for 23% of total purchases in 2010, followed by visitors from Kuwait and the UAE with 10% each, Syria with 8% and Egypt with 7%, while other countries accounted for the remaining 42% of the total amount of tourists in 2010.

Purchases by visitors from Syria increased from a low base by 64.7% in 2018, followed by purchases by tourists from Qatar (+60.5%), Egypt (+26%), Kuwait (+13.8%), and the United States (+7.1%). In contrast, purchases by visitors from Canada decreased by 20.6% in 2018, followed by those from Saudi Arabia (-15.1%), Jordan (-5.5%), the UAE (-3.8%), and France (-2.2%).

YEARLY CHANGE IN TOURIST SPENDING*



Source: Global Blue

* Based on the change in VAT refunds

The favorable trends in tourist activity trickled down to hotels. According to the EY Middle East Hotel Benchmark Survey, the average occupancy rate at four and five-star hotels in Beirut was 65.1% in 2018 relative to 63.7% in 2017, the fifth highest rate among 14 main Arab markets last year. The average rate per room at Beirut hotels increased by 2.3% year-on-year to US$ 188, while revenues per available room reached US$ 122 in Beirut compared to US$ 117 in 2017.

Further, figures compiled by the Ministry of Tourism show that 912,022 persons used hotels and furnished apartments in Lebanon and spent 2,895,843 nights in such facilities in 2018, leading to an average stay of 3.18 nights per person last year. The survey indicated that 797,823 persons used hotels in Lebanon and spent 2,577,426 nights in such facilities in 2018, while 114,199 persons used furnished apartments and spent 318,417 nights at such accommodations in 2018. The results show that Arab nationals, including Lebanese citizens, accounted for 55.3% of the total number of guests in 2018 and for 59.7% of aggregate nights spent at surveyed hotels and furnished apartments in the country.

Still, the Lebanese hospitality sector has a long way to recover to pre-2011 levels. The World Travel & Tourism Council estimated that the travel and tourism industry's direct and indirect impact was equivalent to 19.1% of overall economic activity in Lebanon in 2018, compared to more than 35% of GDP in 2010. But the sector's overall contribution to GDP increased by 1.3% in real terms in 2018, relative to a year-on-year contraction of 0.9% in 2017 and of 2% in 2016.

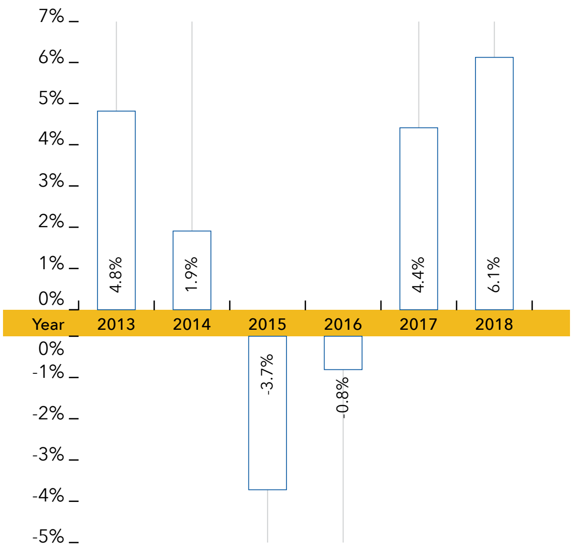
INFLATION

The Consumer Price Index (CPI) increased by 6.1% in 2018, compared to a growth of 4.5% in 2017, according to the Central Administration of Statistics. All components of the CPI increased, especially the prices of clothing and footwear, food and non-alcoholic beverages, as well as those of water, electricity, gas, and other fuels, and transportation costs.

Specifically, the prices of clothing & footwear grew by 15.3% in 2018, followed by the prices of water, electricity, gas & other fuels (+10.8%), transportation costs (+7.9%), recreation & entertainment costs (+7%), and actual rents (+5.6%). Also, the prices of food & non-alcoholic beverages increased by 5.2% year-on-year, healthcare costs grew by 5%, the cost of education rose by 4.4%, and imputed rents and the prices of furnishings & household equipment increased by 3.8% each. In addition, the prices at restaurants & hotels grew by 3.3%, the prices of alcoholic beverages & tobacco rose by 2.9%, miscellaneous goods & services costs increased by 2.6%, and communication costs grew by 1%. The distribution of actual rents shows that old rents grew by 9.1% in 2018, while new rents increased by 3.2% year-on-year.

Inflationary pressure intensified in 2018 due to several factors, including the sharp increase in public-sector wages and the increase in the tax on consumption. Inflationary pressure was also caused by higher oil prices, despite the strengthening of the US dollar in the second half of 2018, which triggered imported inflation. Gasoline prices increased in the local market by about 15% in 2018 and the prices of diesel and gasoil surged by about 27% last year.

INFLATION RATE IN LEBANON (%)



Source: Central Administration of Statistics

In parallel, the 2019 Cost of Living Index, which covers 2018 and is produced by crowd-sourced global database Numbeo, ranked the cost of living in Beirut as the 196th highest among 433 cities around the world and the second highest among 22 Arab cities. Also, the cost of living in Beirut was the highest among 92 cities in upper middle-income countries (UMICs) included in the survey. The Cost of Living Index is an indicator of consumer goods prices, such as groceries, restaurants, transportation and utilities. Numbeo benchmarks the Index against New York City. It also issues a Rent Index, which is an estimation of apartment rents in a city compared to New York City rents. Numbeo relies on residents' inputs and uses data from official sources to compute the indices.

According to the index, rent in Beirut is 70.4% less expensive than in New York City, and is the fifth highest among Arab cities and the fourth highest among cities in UMICs. Also, prices of groceries in Beirut are 54.7% less expensive than they are in New York City, making Beirut the seventh most expensive city in the region and the 10th most expensive among cities in UMICs. Prices of meals and drinks at restaurants and pubs in Beirut are 41.8% less expensive than they are in New York City, which makes the capital the fourth most expensive among Arab cities and the most expensive among cities in UMICs.

MONETARY POLICY

Banque du Liban continued its policy of maintaining the stability of the exchange rate, containing inflation, and safeguarding the soundness of the banking sector throughout 2018. As such, BDL deemed necessary to maintain its special financial operations with the Ministry of Finance and commercial banks amid the lengthy delays in forming a new government, detrimental rumors about monetary stability, the government's increasing financing needs, rising geopolitical tensions, and unfavorable external financing conditions for emerging markets. As such, the International Monetary Fund pointed out in its Article IV Concluding Statement about Lebanon that "Banque du Liban was forced to adopt a tight monetary stance to offset loose fiscal policy."

Through BDL's financial transactions with commercial banks, banks in Lebanon placed long-term US dollar deposits at BDL, funded either from their own liquidity, the sale of dollar-denominated financial instruments, or a combination of both. Against these deposits, BDL granted participating banks advances in Lebanese pounds for an amount equivalent to 1.25 times the value of their US dollar placements in local currency at a 2% interest rate. The banks then either placed these advances with BDL as long-term pledged deposits or purchased Lebanese pound-denominated Treasury bonds.

BDL's operations aimed to attract long-term foreign currency deposits, to preserve its stock of assets in foreign currency, as well as to cover the government's foreign currency refinancing and debt servicing needs. They also aimed to absorb liquidity in Lebanese pounds from the market in order to limit any speculation on the currency, as well as to help banks contain the negative impact of the double taxation on their income. In addition, BDL imposed in August a ceiling of 25% on the banks' loans-to-deposits ratio in Lebanese pounds to further tighten its control on the liquidity available in the market in local currency. BDL excluded subsidized housing loans from the calculation of the loans-to-deposits ratio in Lebanese pounds and gave banks until the end of 2019 to comply with the new limit.

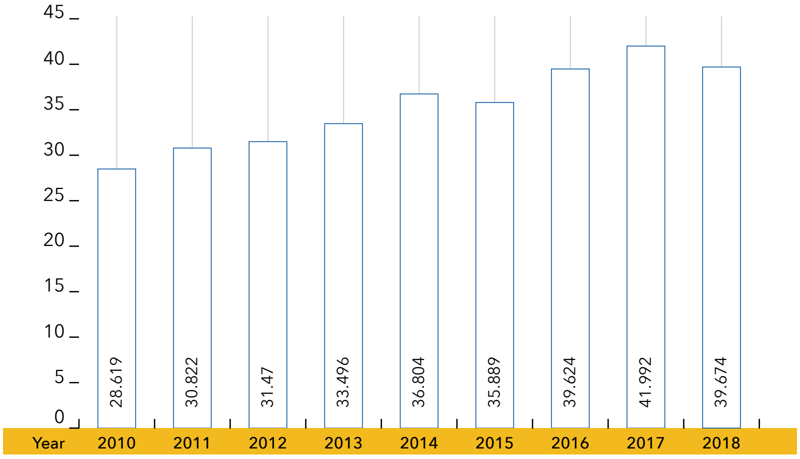
BDL's operations with commercial banks and the Ministry of Finance as well as BDL's interventions in the currency market to purchase US dollars in the first two months of the year, helped BDL's foreign assets reached a record high of US$ 45.3 billion at the end of May 2018. BDL's foreign assets, which along with its gold reserves that amounted to about US$ 12 billion at the time, constituted a strong buffer to preserve monetary stability.

However, foreign assets gradually decreased amid external and local pressure, and reached US$ 43.2 billion at the end of October 2018. In fact, BDL indicated that it had to intervene in the currency market and to supply US dollars from March 2018 until the end of the year due to political tensions in the run-up to the Parliamentary elections that took place in May 2018, and especially to the protracted delays in forming a new post-elections government. In addition, BDL noted that it settled a total of US$ 2.6 billion in debt between November 1 and December 15, 2018, including principal and coupons on maturing Eurobonds. This contributed to a decline in its foreign assets to US$ 40.9 billion at end-November and to US$ 39.7 billion at year-end.

Even though BDL intervened in the currency market throughout most of 2018 and settled all the government's foreign obligations, its assets in foreign currency declined by only US$ 2.3 billion in 2018. Also, the value of its gold reserves regressed by US$ 192 million to US$ 11.8 billion due to lower gold prices. BDL's combined assets in gold and foreign currencies were equivalent to nearly 92% of GDP at the end of the year. Further, Lebanon held 286.8 tons of gold at the end of 2018, giving it the 18th largest gold stock in the world as well as the second largest among Arab countries.

In addition, BDL's gross foreign currency reserves reached US$ 32.5 billion at the end of 2018, constituting a decrease of 9.2% from the end of 2017. They were equivalent to 64% of money supply (M2) at the end of 2018 and to about 14 months' worth of next year's expected imports, well above the four-month reference for emerging markets.

GROSS ASSETS IN FOREIGN CURRENCY (US$ billion)



Source: Banque du Liban

Further, while the interbank rate in Lebanese pounds ended each month of the year at between 4% and 5% in 2018, the end-of-month values masked significant fluctuations that occurred throughout the fourth quarter of the year. During this period, shortages of liquidity in Lebanese pounds at some banks led the interbank rate to peak at about 75% on December 14, 2018. Specifically, the interbank rate on funds in Lebanese pounds, weighted by daily volumes, gradually increased from 4% in January 2018 to 6.27% in August, before regressing to 5.04% in September. It then jumped to 14.6% in October 2018, to 17.1% in November and to 40.11% in December 2018. The repo rate was unchanged at 10% throughout 2018.

In addition, competition persisted among local banks to attract deposits in local and foreign currencies alike. The prevailing conditions, along with higher global and regional interest rates, led to an increase in the interest rates on deposits in both local and foreign currencies. As such, the weighted interest rate on deposits in Lebanese pounds increased from 6.41% in December 2017 to 8.3% in December 2018, while the weighted interest rate on US dollar deposits gradually increased from 3.89% in December 2017 to 5.15% in December 2018.

In parallel, money supply M1, which includes currency in circulation and demand deposits in Lebanese pounds, increased by 9.8% in 2018, while money supply M2, which includes M1 and term deposits in Lebanese pounds, decreased by 3%. Further, broad money supply M3 grew by 1.9% in 2018, down from growth rates of 4.2% in 2017 and 7.4% in 2016, while money supply M2 declined by 3% in 2018, compared to a decrease of 4% in 2017 and to an increase of 4.8% in 2016.

The net foreign assets of the financial sector, a proxy for Lebanon's balance of payments, dropped by US$ 4.8 billion in 2018 compared to a decrease of US$ 115.7 million in 2017. The decline in 2018 was caused by a decrease of US$ 2.5 billion in the net foreign assets of banks and financial institutions and by a contraction of US$ 2.3 billion in those of BDL. The drop in the net foreign assets of the financial sector in 2018 was mainly due to the fact that BDL settled a total of US$ 2.6 billion in external obligations on behalf of the government between November 1 and December 15, 2018, as well as to deposit outflows of US$ 1.1 billion in the second half of the year.

EXTERNAL SECTOR

The current account deficit reached US$ 12.4 billion, or 22.2% of GDP, in 2018, compared to a deficit of US$ 12.1 billion, or 22.7% of GDP, in 2017. The current account balance consists of the trade balance, which is the exports and imports of merchandise, as well as the services balance that cover the export and import of transportation services, tourism, insurance and other services. The current account balance also includes the remittance inflows, investment income and general government transfers

The current account balance, a component of the balance of payments, has historically posted deficits due mostly to the deficit in the trade in goods, and this deficit was nearly identical in 2018 and 2017. But it was the deterioration in the financial account, and to a lesser extent in the capital account, that exacerbated the deficit in the balance of payments in 2018. Even though the capital and financial accounts posted surpluses in 2018, portfolio outflows were the main reason for the sharp decline in this surplus, while net foreign direct investments were very modest and could not offset the portfolio outflows, in the absence of a long-term vision and a concrete strategy to attract such investments to the country.

The trade deficit reached US$ 17 billion in 2018, widening by 1.7% year-on-year, as the amount of imported goods increased by 2% to US$ 20 billion and the value of exports grew by 3.8% to US$ 3 billion. The rise in imports was mainly due to an increase of US$ 530 million, or 3.5%, in the amount of non-hydrocarbon imports to US$ 15.8 billion in 2018. It was offset in part by a decrease of US$ 132.6 million, or 3.1%, in the imports of oil and mineral fuels to US$ 4.2 billion in 2018. Imports were equivalent to 35.6% of GDP and exports to 5.3% of GDP in 2018, leading to a trade deficit equivalent to 30.4% of GDP.

In parallel, the inflows of expatriates' remittances to Lebanon reached US$ 6.9 billion in 2018, constituting a decrease of 1.7% from US$ 7.1 billion in 2017. Further, remittance inflows to Lebanon were equivalent to 12.4% of GDP in 2018 compared to 13.2% of GDP in 2017. In addition, remittance outflows from Lebanon amounted to US$ 4.8 billion, or 8.6% of GDP, in 2018, up by 8.7% from US$ 4.5 billion in 2017. As such, net remittance inflows to Lebanon reached US$ 2.1 billion in 2018, constituting a decrease of 19.5% from US$ 2.6 billion in 2017. They were equivalent to 3.7% of GDP in 2018, down from 4.9% of GDP in 2017.

In addition, tourist receipts amounted to US$ 8.4 billion in 2018, constituting an increase of 10.4% from US$ 7.6 billion in 2017. They were equivalent to 15% of GDP in 2018, up from 14.3% of GDP in 2017 and relative to an annual average of 20% of GDP during the 2007-10 period.

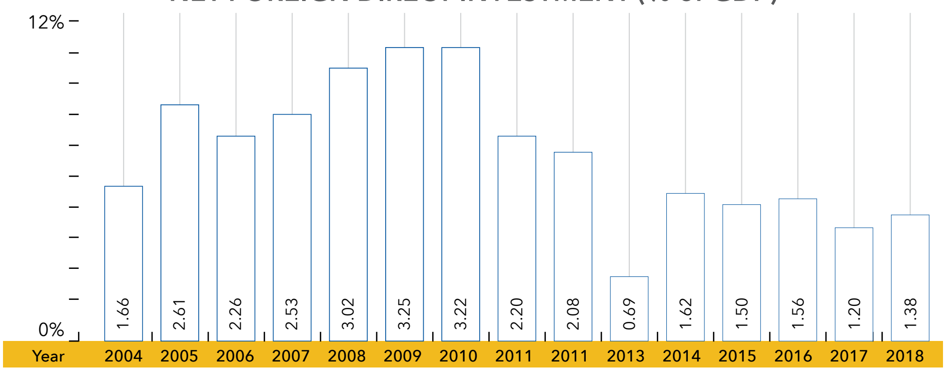
Further, outbound tourist spending reached a record high of US$ 6.3 billion in 2018, up by 12% from US$ 5.6 billion in 2017, and recorded the second highest value on record. The spending of Lebanese visitors abroad was equivalent to 11.1% of GDP last year compared to 10.5% of GDP in 2017. As such, net tourist receipts totaled US$ 2.1 billion in 2018, up by 6% from US$ 2.02 billion in 2017. They were equivalent to 3.8% of GDP in 2018, unchanged from 2017, and down from an annual average of 9.8% of GDP between 2002 and 2011.

In parallel, Lebanon's capital account balance, which includes foreign grants, posted a surplus of US$ 1.6 billion in 2018, down by 9.6% from US$ 1.7 billion in 2017, and representing the lowest surplus the US$ 1.4 billion registered in 2014. It was equivalent to 2.8% of GDP in 2018 compared to 3.2% of GDP in 2017. Lebanon's capital account surplus averaged US$ 1.6 billion annually between 2013 and 2018 due to grants received to support Syrian refugees and host communities in the country, compared to an annual average of US$ 157 million between 2009 and 2012.

Further, Lebanon's financial account balance, which includes net foreign direct investment, net portfolio investment and other net investment, posted a surplus of US$ 3.3 billion in 2018, constituting a decline of 70.5% from a surplus of US$ 11.2 billion in 2017. It was equivalent to 5.9% of GDP in 2018 compared to 21% of GDP in 2017. The drop in Lebanon's financial account surplus in 2018 was due to the shift in net portfolio flows from inflows of US$ 5 billion in 2017 to outflows of US$ 1.5 billion in 2018, as well as to the drop in the inflows of other investments, from US$ 5.1 billion in 2017 to 3.4 billion in 2018. Other investments include the inflows of foreign deposits to the banking sector.

In addition, foreign direct investments (FDI) in Lebanon totaled US$ 2.6 billion in 2018, constituting an increase of 4.3% from US$ 2.5 billion in 2017. FDI inflows to Lebanon in 2018 reached their highest level since 2014, but they remained below the peak of US$ 4.4 billion reached in 2009. They were equivalent to 4.7% of GDP in 2018, their second lowest level on record relative to 4.3% of GDP in 2015. Also, FDI outflows from Lebanon amounted to US$ 1.25 billion in 2018, down by 4.9% from US$ 1.3 billion in 2017. They were equivalent to 2.2% of GDP in 2018 relative to 2.5% of GDP in 2017 and reached their fourth lowest level on record. As such, net FDI inflows to Lebanon reached US$ 1.4 billion in 2018 and represented an increase of 14.4% from US$ 1.2 billion in 2017. They were equivalent to 2.5% of GDP in 2018 compared to 2.3% of GDP in 2017.

NET FOREIGN DIRECT INVESTMENT (% of GDP)



Source: Banque du Liban, National Accounts, Byblos Research

PUBLIC FINANCES

Lebanon's public finance imbalances worsened in 2018, mostly due to the increase in the compensation of the public sector's personnel and to shortfalls in public revenues. Other spending items that contributed to the rise in public expenditures include Treasury transfers to municipalities and to the state-owned and money-losing Electricité du Liban (EDL), as well as debt servicing cost. As such, the fiscal deficit widened from US$ 3.8 billion, or 7% of GDP in 2017, to US$ 6.2 billion, or 11.1% of GDP in 2018.

Public expenditures increased by 15.7% to US$ 17.8 billion in 2018. The increase in wages, salaries, benefits, and pension payments, which the Lebanese Parliament enacted in July 2017, expanded the public sector's personnel cost by US$ 1 billion or 18.3% to US$ 6.4 billion in 2018, and represented 36% of total fiscal spending. In addition, debt servicing increased by 8.2% to US$ 5.6 billion (32% of total expenditures), and transfers to EDL surged by 32.3% to US$ 1.8 billion (10% of total spending). In parallel, capital expenditures grew by 16% to US$ 916.7 million in 2018 and accounted for 5.2% of total spending, while Treasury expenditures rose by 34% to US$ 1.2 billion in 2018 (6.6% of total spending), in part due to higher transfers to municipalities.

The compensation of public sector personnel reached the equivalent of 11.5% of GDP in 2018 relative to 10.2% of GDP in 2017, while debt servicing cost was at 10% of GDP last year compared to 9.7% of GDP in 2017. Also, transfers to EDL were equivalent to 3.1% of GDP in 2018 relative to 2.5% of GDP in 2017. Public personnel cost was the fastest-growing component of main fiscal spending over the past eight years, as it expanded by 92% between 2010 and 2018, compared to a growth rate of 47% for Treasury transfers to EDL and of 36% for debt servicing. Overall, public spending increased from the equivalent of 28.8% of GDP in 2017 to 31.7% of GDP in 2018.

In parallel, public revenues regressed by 0.7% to US$ 11.5 billion in 2018, even though the rise in taxes and fees, which went into effect at the start of 2018, were supposed to cover the increase in wages and salaries and to generate additional revenues. In fact, the new tax measures backfired as they exacerbated tax evasion in the country, increased operating costs and further depressed domestic consumption and overall economic activity. As such, public revenues regressed from 21.8% of GDP in 2017 to 20.6% of GDP in 2018.

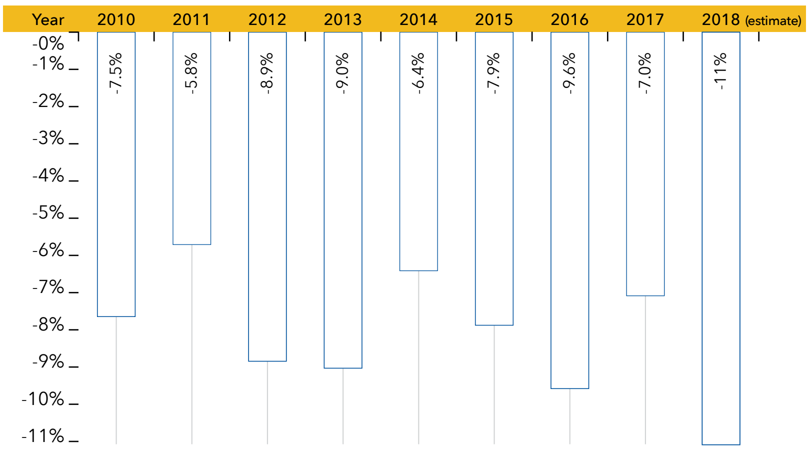
Tax receipts grew by 3.1% to US$ 8.5 billion in 2018, of which 30.1%, or US$ 2.5 billion, were in value-added tax receipts that increased by 10.5% annually. The rise in VAT receipts reflects the increase in the tax rate by one percentage point to 11% that was enforced in 2018, but that constitutes an effective increase of 10%. The distribution of other tax revenues shows that receipts from taxes on income, profits & capital gains increased by 7.1% annually to US$ 3 billion in 2018, while revenues from customs regressed by 6.4% to US$ 1.3 billion. Also, receipts from property taxes dropped by 19.4% to US$ 755.4 million; while revenues from taxes on goods & services increased by 9.2% to US$ 437.2 million and receipts from stamp fees expanded by 15% to US$ 399.4 million.

In addition, the distribution of tax receipts from income, profits & capital gains shows that the tax on interest income accounted for 40% of income tax revenues in 2018, followed by the tax on profits with 30.2%, taxes on wages & salaries with 19.3%, and the capital gains tax with 9.3%. Receipts from the tax on interest income surged by 99.1% in 2018, following the increase from 5% to 7% in the tax rate on interest income and due to the fact that banks pay these taxes in full and collect the tax on deposit interest rates on behalf of the government. Also, revenues from taxes on capital gains grew by 17.1% mostly due to the rise in the dividend tax from 5% to 10%, while receipts from taxes on wages & salaries increased by 13.1% last year. In contrast, revenues from taxes on profits dropped by 35.4% in 2018, even though the corporate income tax rate increased from 15% to 17%. The decline in the receipts from taxes on profits is mainly due to tax evasion, as well as to the fact that banks paid a one-time tax in 2017 on the profits they generated from their financial operations with BDL in 2016, which significantly increased receipts from taxes on profits during that year.

Overall, tax revenues were equivalent to 15.1% of GDP in 2018 relative to 15.4% of GDP in 2017. In comparison, aggregate tax receipts were equivalent to 15% of total GDP during the 2010-18 period, which demonstrates that the across-the-board and arbitrary tax hikes failed to generate additional revenues and hurt economic activity.

Further, non-tax budgetary receipts decreased by 11.5% to US$ 2.3 billion in 2018. They mainly included US$ 1.1 billion in receipts from telecommunication services that dropped by 16.6% from 2017. Non-tax budgetary receipts were equivalent to 4% of GDP last year relative to 4.8% of GDP in 2017.

FISCAL BALANCE (% of GDP)



Source: Ministry of Finance, Central Administration of Statistics, Institute of International Finance

The widening of the fiscal deficit exacerbated Lebanon's debt dynamics, as the gross public debt reached US$ 85.1 billion at the end of 2018, constituting a rise of 7% from US$ 79.5 billion at the end of 2017 and compared to increases of 6.2% in 2017 and 6.5% in 2016. In nominal terms, the gross public debt grew by US$ 5.6 billion in 2018, relative to increases of US$ 4.64 billion in 2017 and US$ 4.56 billion in 2016. The public debt level was equivalent to 151.5% of GDP in 2018 relative to 149% of GDP in 2017. Further, the net public debt, which excludes public sector deposits at BDL and at commercial banks from overall debt figures, grew by 9.5% annually to US$ 75.7 billion at end-2018, equivalent to 134.8% of GDP.

Debt denominated in Lebanese pounds totaled US$ 51.6 billion at the end of 2018, growing by US$ 2.5 billion or by 5.1% from end-2017; while debt denominated in foreign currency stood at US$ 33.5 billion, constituting a rise of US$ 3.1 billion or 10.2% from end-2017. Local currency debt accounted for 60.7% of the public debt at end-2018 compared to 61.8% a year earlier, while foreign currency denominated debt represented the balance of 39.3% relative to 38.2% at end-2017. In May 2018, the Finance Ministry issued US$ 5.5 billion in Lebanese Eurobonds and exchanged them with LBP 8,250 billion worth of Lebanese pound-denominated Treasury bills from BDL's portfolio in order to reduce the cost of debt servicing, which explains the growth in foreign-currency debt. In addition, BDL subscribed to LBP 8,250 billion worth of Treasury bonds that the ministry issued between May and December 2018, and that carried an interest rate of 1%, as part of the deal between the two parties. The ministry estimated that its operations with BDL saved the equivalent of US$ 1.4 billion in debt servicing cost for the Treasury.

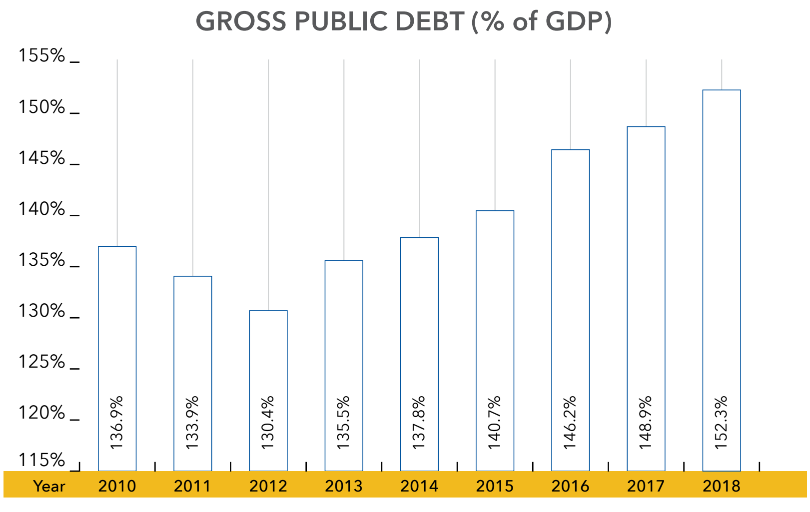
The distribution of outstanding Treasury securities denominated in Lebanese pounds at end-2018 shows that 10-year Treasury bonds accounted for 27.6% of securities in the local currency and five-year Treasury securities represented 23.2% of the total, while the share of seven-year Treasury bonds was 14.8% and the share of three-year Treasury bonds was 13.5% of the total. Also, outstanding two-year Treasury bills accounted for 9.1% of total securities at the end of 2018 and 12-year Treasury securities represented 4%, while the share of eight-year Treasury securities was 2.4% and the share of 15-year Treasury bonds was 1.9%. In addition, 3.6% of outstanding Treasury securities had a maturity of one year or less at the end of 2018. As such, 50.7% of outstanding Treasury securities at the end of 2018 had maturities of seven years or longer and 73.9% had maturities of five years or more. The weighted interest rate on Lebanese Treasury securities denominated in Lebanese pounds was 6.11% in December 2018 compared to 6.65% in December 2017. Also, the weighted life of Treasury bills and bonds was 1,628 days at the end of 2018 compared to 1,420 days a year earlier. The structure of the public debt shows that the BDL held about 50% of the Lebanese pound-denominated public debt at the end of 2018, followed by commercial banks with about 35%, and public agencies, financial institutions, and the public with about 15%.

Further, holders of Eurobonds and special T-bills in foreign currencies accounted for 93.7% of foreign currency-denominated debt holders at the end of 2018, followed by bilateral and multilateral institutions with 4.1% and foreign governments with 2.2%. The banking sector, including BDL, held nearly 75% of Lebanon's Eurobonds at the end of 2018. The weighted interest rate on Eurobonds was 6.81% in December 2018 relative to 6.49% in December 2017. Also, the weighted life of Eurobonds was 7.83 years at the end of 2018 relative to 7.07 years at end-2017.

The profile of Lebanon's public debt remained manageable in 2018 despite the rise in the debt stock due to several factors. First, local financial institutions hold the majority of Lebanon's gross public debt, which protects Lebanon from shifts in foreign investor sentiment. Specifically, commercial banks held nearly 40% of the gross public debt at the end of 2018, followed by BDL with around 34%, and non-bank Lebanese financial institutions with nearly 9%. As a result, foreign investors held about 14% of the public debt stock as at the end of 2018, while bilateral and multilateral loans represented around 2% of the debt stock.

Second, Lebanon's gross market debt accounted for 59.4% of the total public debt at the end of 2018. Gross market debt is the total public debt less the portfolios of BDL, the National Social Security Fund, bilateral and multilateral loans, as well as Paris III related debt. As such, the gross market debt was equivalent to 90% of GDP in 2018 compared to a gross public debt level of 151.5% of GDP in the same year.

Third, BDL's assets in foreign currency, which stood at US$ 39.7 billion at the end of 2018, comfortably covered the government's debt denominated in foreign currency of US$ 33.5 billion. In comparison, Turkey's public external debt amounted to US$ 140.6 billion at the end of 2018, while its foreign currency reserves were nearly half of the debt at US$ 71.4 billion. Also, Egypt's external debt reached US$ 96.6 billion at the end of 2018, and significantly exceeded the country's stock of foreign currency of US$ 39.2 billion.



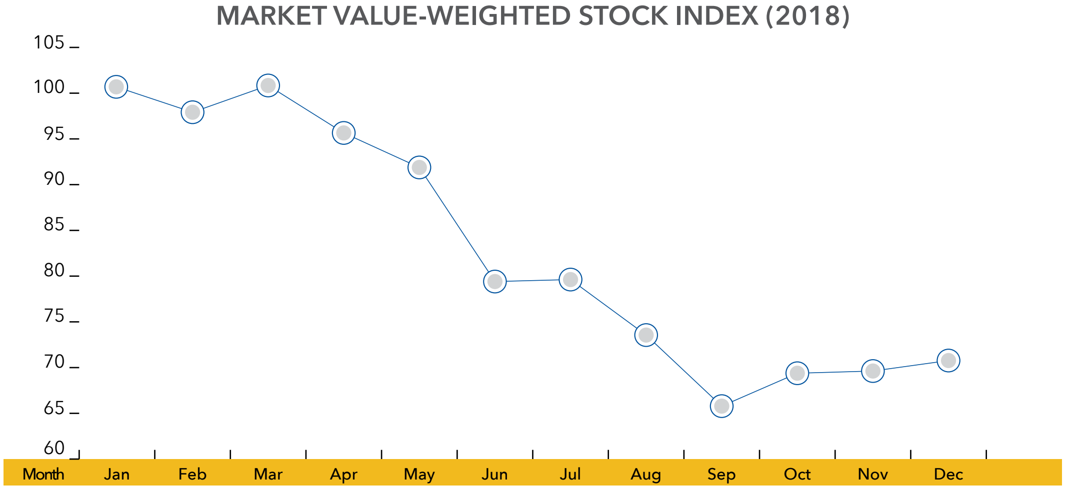
Source: Ministry of Finance, Central Administration of Statistics, Institute of International Finance

CAPITAL MARKETS

EQUITIES

The Beirut stock market continued to suffer from low liquidity and a lack of interest from privately held and family-owned firms in listing their shares. In addition, stock prices declined in 2018, mainly due to an increase of 100% in the tax rate on dividend distribution, which prompted a wave of selling by shareholders. Total trading volume on the Beirut Stock Exchange (BSE) reached 90 million shares in 2018, constituting an increase of 3.5% from 87 million shares traded in 2017, while aggregate turnover amounted to US$ 633.6 million, down by 16.9% from a turnover of US$ 762.1 million in 2017. Market capitalization regressed by 15.7% from the end of 2017 to US$ 9.68 billion, with banking stocks accounting for 84.2% of total market capitalization, followed by real estate shares (12.1%), industrial firms (3.4%), and trading stocks (0.4%). The market liquidity ratio was 6.5% in 2018, nearly unchanged from 6.6% in 2017. Further, market capitalization was equivalent to 17.2% of GDP in 2018, the sixth lowest level among 15 Arab markets, and accounted for about 0.8% of the aggregate market capitalization of Arab equity markets at the end of the year.

Banking stocks accounted for 77.5% of the aggregate trading volume in 2018, followed by real estate equities with 20.1%, industrial shares with 2.1%, and trading stocks with 0.3%. Also, banking stocks represented 74% of the aggregate value of traded shares, followed by real estate equities with 21.6%, industrial stocks with 4.2%, and shares of trading firms with 0.1%. The average daily traded volume for 2018 was 375,059 shares for an average daily value of US$ 2.6 million. The figures show an increase of 4.3% in the average volume and a decline of 16.2% in the average value of traded shares in 2018. In parallel, the Capital Markets Authority's Market Value-Weighted Index for stocks traded on the BSE dropped by 25.1% in 2018, while its Banks Market Value-Weighted Index regressed by 27%.



Source: Capital Markets Authority

FIXED INCOME

Lebanon's external debt posted a return of -5.62% in 2018, constituting the 12th lowest return among 44 markets in the Central and Eastern Europe, Middle East and Africa region, as well as the 17th lowest return among 77 emerging markets, according to Intercontinental Exchange's External Debt EM Sovereign Index. Lebanon underperformed the overall emerging markets return of -3.6% during 2018, and posted the 11th lowest return among 27 countries in the Middle East and Africa region, due mostly to external factors but also to domestic factors. Lebanon's external debt posted a return of 2.27% in the first quarter of 2018, as well as returns of -12% in the second quarter, 1.81% in the third quarter, and 2.98% in the fourth quarter of last year.

The Ministry of Finance issued a total of US$ 5.5 billion in Eurobonds in 2018. In May 2018, the ministry issued a US$ 5.5 billion four-tranche Eurobond that it swapped with LBP 8,250 billion worth of Lebanese pound-denominated Treasury bills from BDL's portfolio. The first tranche consisted of reopening and increasing by US$ 1 billion an existing bond that matures in March 2028 and carries a coupon of 7%, while the second tranche consisted of reopening and increasing by US$ 1.5 billion an existing bond that matures in November 2031 and that carries a coupon of 7.15%. The third tranche consisted of issuing a 15-year US$ 1.5 billion Eurobond that matures in May 2033 and carries a coupon of 8.2%, while the fourth consisted of a 16-year US$ 1.5 billion Eurobond that matures in May 2034 and carries a coupon of 8.25%. The proceeds of the issuance were mainly used to cover the government's refinancing needs and debt servicing in foreign currency until the end of 2018. Also, the swap operation helped BDL strengthen its assets in foreign currency through the acquisition of the Eurobonds. In addition, BDL subscribed to LBP 8,250 billion worth of Treasury bonds that the ministry issued throughout the year, which had maturities ranging between three and 10 years and that carry an interest rate of 1%. The ministry estimated that its operations with BDL saved the equivalent of US$ 1.4 billion in debt servicing cost for the Treasury in 2018.

In parallel, in early December 2018, the Ministry of Finance reached an agreement with BDL and the Association of Banks in Lebanon to issue new sovereign debt in local currency at market rates. The agreement aimed to encourage commercial banks to subscribe to Treasury bonds, while BDL would subscribe to additional issuances in case of need. In fact, there were diverging viewpoints between commercial banks and BDL on one hand, and the Ministry of Finance on the other hand, about the rates on the new sovereign debt instruments issued in local currency. The offered rates by the government prior to the agreement did not reflect the increase in the interest rates that banks paid on deposits, which discouraged the banking system from subscribing to sovereign debt issuances in local currency. As such, in December 2018, the Finance Ministry issued LBP 1,002 billion in 10-year LBP Treasury bonds that carry a coupon rate of 10%, as well as LBP 1,202 billion in 15-year LBP Treasury bonds at a coupon rate of 10.5%. Prior to the agreement, the 10-year Treasury bonds carried a coupon rate of 7.46%.

RISK METRICS

According to Intercontinental Exchange's Credit Market Analysis, spreads on five-year credit default swaps (CDSs) for Lebanon ended 2018 at 774 basis points (bps), compared to 521 bps at the end of 2017. The spreads narrowed to 443 bps at end-March 2018 in the run-up to the CEDRE conference that was held on April 6 in Paris. But they started widening afterwards and ended June at 721 bps, due to the normalization of global interest rates and its impact on foreign investors' appetite for emerging-markets fixed income securities, given that Lebanese Eurobonds are part of this space. Lebanon's CDS spreads slightly narrowed to 656 bps at the end of August 2018, but jumped to 839 bps on September 17 amid delays in the formation of a new government and unfavorable external conditions for emerging markets. They narrowed afterward, reaching 686 bps at the end of September 2018.

However, the spreads widened again to 774 bps at the end of the year due to foreign investors' increased risk perception of Lebanese Eurobonds amid the persisting delays in the formation of a new government, repeated local negative rumors about the Lebanese economy and the national currency, rising geopolitical tensions, some unfavorable reports from global investment banks, in addition to the normalization of global interest rates.

The adverse impact of domestic political uncertainties on policy-making, the worsening of fiscal and external imbalances, as well as the effect of higher global and regional interest rates on deposit inflows, affected the outlook on the sovereign ratings, even though rating agencies remained confident in the currency peg to the US dollar and in the strength of the banking sector. As a result, in December 2018 Fitch Ratings affirmed Lebanon's long-term foreign and local currency Issuer Default Ratings at 'B-', but revised the outlook on the ratings from 'stable' to 'negative'. In the same month, Moody's Investors Service affirmed Lebanon's issuer rating at 'B3' and revised the outlook from 'stable' to 'negative'. Also, Capital Intelligence Ratings affirmed in November 2018 Lebanon's long- and short-term foreign and local currency sovereign ratings at 'B', and revised the outlook from 'stable' to 'negative' on the long-term ratings. S&P Global Ratings was the only rating agency that kept its 'stable' outlook on Lebanon's long-term sovereign ratings. In August 2018, the agency affirmed Lebanon's long- and short-term foreign and local currency sovereign credit ratings at 'B-/B', with a 'stable' outlook.

BANKING SECTOR

The banking sector faced a challenging operating environment in 2018 due to several converging factors that consist of slowing economic activity in Lebanon, higher and arbitrary taxes that included the double taxation of the banks' income, tighter margins, and fewer lending opportunities domestically, as well as the elevated borrowing needs of the Lebanese government. In addition, higher global interest rates and strong competition for foreign capital from regional economies weighed on the banks' deposit growth. Still, the banking sector remained solid, profitable, liquid, and able to meet the financing needs of the private and public sectors. Rating agencies continued to restrain the banks' ratings to the sovereign ceiling, citing the banks' elevated exposure to the sovereign as their most important risk factor. There were 49 commercial banks operating in Lebanon at the end of 2018, unchanged from end-2017, with 1,080 branches across Lebanon relative to 1,065 at end-2017. A such, were 103 branches of commercial banks per 1,000 square kilometers in Lebanon in 2018, compared to 102 branches per 1,000 square kilometers in 2017. Also, there were 22.1 bank branches per 100,000 individuals in Lebanon in 2018, up from 21.8 branches per 100,000 persons in 2017.

The aggregate assets of commercial banks in Lebanon reached US$ 249.5 billion at the end of 2018, constituting an increase of 13.5% from end-2017. The sector's assets were equivalent to about 445% of GDP, one of the highest such ratios in the world.

Loans to the private sector reached US$ 59.4 billion, or nearly 106% of GDP, at the end of 2018, constituting a decline of 0.5% from end-2017 and accounting for 23.8% of total assets. Loans to the resident private sector totaled US$ 52.3 billion (93% of GDP), down by 2.5% from the end of 2017, while credit to the non-resident private sector reached US$ 7.1 billion at end-2018, up by 17.2% from a year earlier. In nominal terms, credit to the private sector regressed by US$ 300 million in 2018, as lending to the resident private sector contracted by US$ 1.3 billion and credit to the non-resident private sector grew by US$ 1 billion during the year. The decline in lending to the private sector was due to the limited lending opportunities in the local market, the increase in interest rates that discouraged customer demand for credit, some companies reducing their credit exposure, as well as to the banks' risk aversion amid the challenging economic environment in the country. In fact, subdued activity in the country weighed on some companies' cash flow and reduced their ability to service credit facilities.

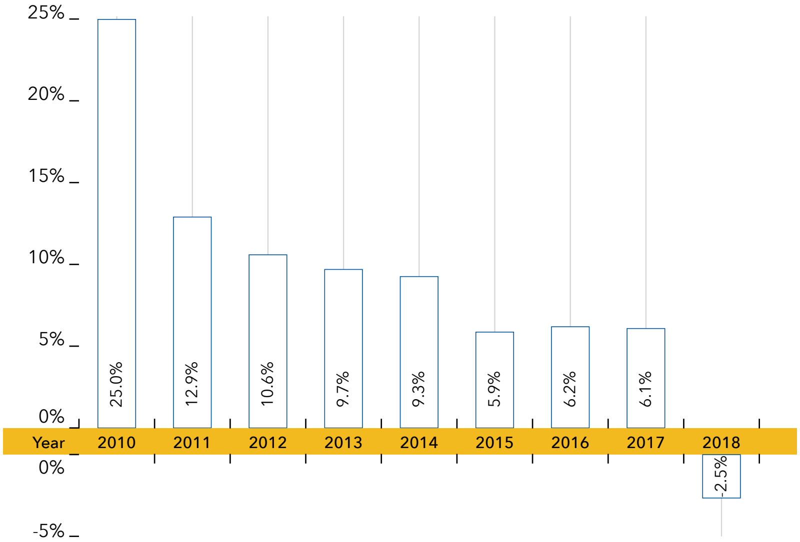
The weighted average lending rate in Lebanese pounds was 9.97% in December 2018 compared to 8.09% a year earlier, while the same rate in US dollars was 8.57% relative to 7.67% in December 2017. The increase in the banks' lending rates follow the same trend in the interest rates on deposits. Also, The dollarization rate in private sector lending rose from 68.6% at end-2017 to 69.2% at end-2018 mostly due to BDL's introduction in August 2018 of a 25% ceiling on the banks' loans-to-deposits ratio in Lebanese pounds. In fact, banks encouraged their customers to convert their loans in Lebanese pounds to US dollars in order to comply with BDL's new requirements. Also, BDL allowed customers to reschedule loans that were extended under BDL's stimulus packages if the loan is originally granted in Lebanese pounds and the client converted it to US dollars.

Private sector lending activity during the year shows that trade & services accounted for 34.1% of utilized credits at the end of 2018, followed by consumer loans (30.4%), the construction sector (16%), the industrial sector (11%), financial intermediaries (4.5%), and the agricultural sector (1.1%), while utilized credits by other sectors represented the remaining 2.9%. At the sub-sector level, housing loans accounted for 18.5% of total utilized credits at end-2018, followed by wholesale trade (16.7%), manufacturing (9.3%), retail trade (5.7%), real estate services (5.2%), transport & storage (2.4%), and hotels & restaurants (2.3%).

Utilized credits by the wholesale sub-sector surged by 11.7% and those for educational services grew by 8.4% in 2018, while credits by the hotels & restaurants sector and by the retail trade sector regressed by 3.3% and 1.5%, respectively, last year. Also, utilized credits by the industrial and agricultural sectors expanded by 11.6% and 0.5%, respectively, in 2018. However, utilized credits by the construction sector, which covers contractors, sub-contractors and developers, tightened by 2.6% during the year; while credit for real estate services declined by 3.8%. In addition, utilized consumer loans regressed by 1.4% in 2018.

Also, the distribution of bank credit by type shows that advances against real estate totaled US$ 27 billion and accounted for 39% of private sector utilized credits at the end of 2018. Overdrafts followed with US$ 18.7 billion (27%), then advances against personal guarantees with US$ 11.9 billion (17%), advances against cash collateral or bank guarantees with US$ 8.8 billion (12.6%), advances against other real guarantees with US$ 1.9 billion (2.7%) and advances against financial values with US$ 1.3 billion (1.8%).

RESIDENT PRIVATE SECTOR LENDING GROWTH (% change)



Source: Association of Banks in Lebanon, Byblos Research

Further, the banking sector's claims on the public sector stood at US$ 33.6 billion at end-2018, up by 5.2% from a year earlier, and accounted for 13.5% of the banking sector's total assets. Also, commercial banks' deposits at the BDL totaled US$ 130.2 billion at end-2018, as they increased by US$ 26.8 billion or by 26% from a year earlier due to the BDL's financial operations with commercial banks, and accounted for 52.2% of the sector's aggregate assets. In addition, BDL's operations helped absorb liquidity in Lebanese pounds and US dollars in order to prevent any potential speculation against the local currency. In parallel, the banks' immediate liquidity, which includes claims on non-resident financial institutions and deposits with non-resident central banks, stood at a solid US$ 13 billion at the end of 2018, up by US$ 631 million, or by 5.1%, from end-2017 and constituted an important buffer in foreign currency for Lebanese banks.

The political deadlock that prevailed in the second half of 2018 constituted another episode of uncertainties that demonstrated the resilience of bank deposits. Despite political uncertainties in the country and the adverse external environment, deposit outflows from Lebanon totaled about US$ 1.1 billion, representing just 0.6% of the banks' aggregate deposits at the end of 2018. The stability of deposits reflects the increased efforts by the BDL and domestic banks to attract foreign currency deposits, counter the negative rumors about the currency and the economy, as well as address the conversion of deposits to US dollars and the outflows of deposits from the banking sector. In fact, deposits of the private sector totaled US$ 174.3 billion at the end of 2018 and increased by US$ 5.62 billion, or 3.3%, from end-2017, relative to a growth of US$ 6.17 billion, or 3.8%, in 2017. Still, the nominal increase in private sector deposits in 2018 was the lowest since 2006, when they grew by US$ 3.7 billion.

Private sector deposits were equivalent to 311% of GDP in 2018, one of the highest such ratios in the world. Deposits in Lebanese pounds reached the equivalent of US$ 51.2 billion, and regressed by 2.9% from end-2017, while deposits in foreign currencies totaled US$ 123.1 billion, and rose by 6.2% from end-2017. The decrease in Lebanese pound deposits was mostly due to delays in forming a new government and to detrimental rumors that affected depositors' confidence and triggered conversions to US dollars. However, non-resident deposits reached US$ 37.7 billion at the end of 2018 and increased by 7.3% from end-2017, which reflects the sustained confidence of Lebanese expatriates in the country's banking system. In nominal terms, non-resident deposits increased by US$ 2.6 billion in 2018, the highest increase since 2013, when they grew by US$ 4.4 billion.

The distribution of bank deposits at commercial banks in Lebanon shows that term deposits were the preferred type of account for resident and non-resident depositors in Lebanese pounds and in foreign currency at the end of 2018. Term deposits in all currencies reached US$ 167.3 billion at the end of 2018, constituting an increase of 3% from US$ 162.5 billion at end-2017. They accounted for 89.1% of total deposits in Lebanese pounds and in foreign currency at end-2018 relative to a share of 90% at end-2017.

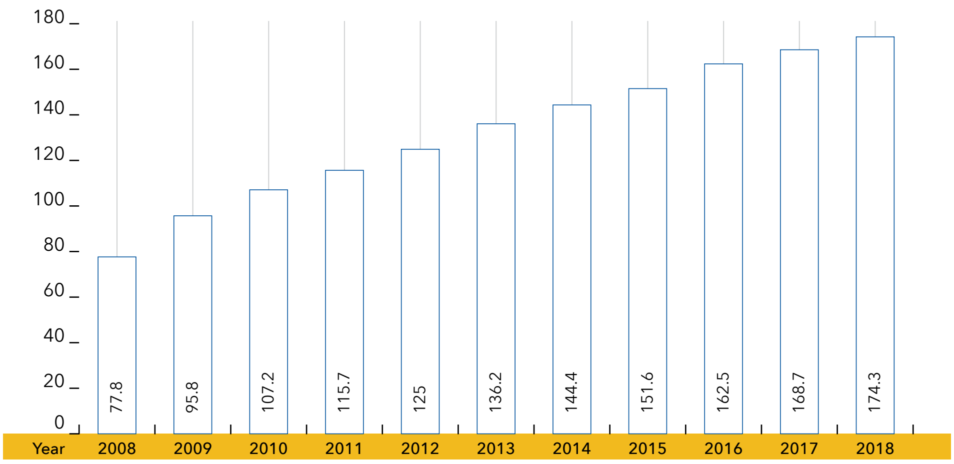
Term deposits of the resident private sector in foreign currency totaled US$ 79.5 billion and accounted for 42.4% of total deposits at the end of 2018. Term deposits of the resident private sector in Lebanese pounds followed with US$ 42.3 billion (22.5%), then term deposits of non-resident customers with US$ 34.4 billion (18.3%), and term deposits of the non-resident financial sector with US$ 7.1 billion (3.8%). Also, term deposits of the public sector in Lebanese pounds total US$ 3.7 billion (2%) at end-2018, and term deposits of the public sector in foreign currency amounted to US$ 158.6 million (0.1%).

In parallel, demand deposits of the resident private sector in foreign currency amounted to US$ 10.1 billion and represented 5.4% of total deposits at the end of 2018. Demand deposits of the resident private sector in Lebanese pounds followed with US$ 4.6 billion (2.4%), then demand deposits of non-resident customers with US$ 3.3 billion (1.8%), and demand deposits of the non-resident financial sector with US$ 2.1 billion (1.1%). Also, demand deposits of the public sector in Lebanese pounds totaled US$ 301.4 million (0.2%) at end-2018, and public-sector demand deposits in foreign currency amounted to US$ 126.1 million (0.1%).

The dollarization rate of private sector deposits reached 70.6% at the end of 2018 relative to 68.7% at end-2017, with most of the increase occurring in the fourth quarter of 2018 amid rising political uncertainties. In parallel, deposits of non-resident financial institutions reached US$ 9.3 billion at the end of 2018, constituting a growth of 23.8% from end-2017.

In parallel, interest rates in Lebanon increased in 2018, reflecting the rise in global interest rates, the competition between local banks for deposits, the competition with regional countries for capital flows, as well as the rise in Lebanon's risk profile. The average deposit rate in Lebanese pounds was 8.3% in December 2018 compared to 6.41% a year earlier, while the same rate in US dollars was 5.15% relative to 3.89% in December 2017.

PRIVATE SECTOR DEPOSITS (US$ billion)



Source: Association of Banks in Lebanon, Byblos Research

The Lebanese banking sector maintained a high level of liquidity in 2018, as the ratio of private sector loans to deposits in foreign currencies stood at 33.4% at the end of 2018, well below BDL's limit of 70%, and compared to 35.3% a year earlier. In parallel, the same ratio in Lebanese pounds was 35.7% at end-2018 relative to 35.5% at the end of 2017. As such, the total private sector loans-to-deposits ratio reached 34.1% at end-2018, down from 35.4% at end-2017. Further, the banks' aggregate capital base stood at US$ 20.2 billion at the end of 2018, up by 5.4% from a year earlier, with core capital growing by 4.7% year-on-year to US$ 18.7 billion.

The banking sector has been the subject of double taxation under Tax Law 64 that Parliament enacted in October 2017. According to the law, the revenues that banks generate from their investments in government securities and placements at BDL are subject to the 7% income tax rate, which BDL withholds on behalf of the Lebanese government. Then, these revenues, net of the income tax, are subject to a second tax, which is the corporate income tax rate of 17%, as part of the bank's total profits. The Association of Banks in Lebanon estimated that banks are paying an effective tax rate of about 45% on their income due to the double taxation, compared to the income tax rate of 17% that corporates in other sectors are paying. It added that the double taxation has cost banks about US$ 750 million in lost income in 2018.

As part of their commitment to transparency, commercial banks declare their income in full to tax authorities. They also pay all of their taxes and the taxes dues on the wages and salries of their employees, as part of their full compliance with laws, rules and regulations. This has exposed the level of tax evasion in the economy, as revenues from the corporate tax that the banking sector pays accounts for 60% income of the government's receipts from the corporate income tax. Also, the banking sector generates 33% of the government's total revenues from the capital gain tax. In addition, the tax on wages and salaries of employees in the banking sector accounts for 20% of the government's receipts , according to the calculations of the Association of Banks in Lebanon.

In parallel, the consolidated profits of banks operating in Lebanon reached US$ 2.2 billion in 2018, constituting a drop of 2.9% from net earnings of US$ 2.3 billion in 2017. As a result, the banks' return on average assets regressed from 1.06% in 2017 to 0.93% in 2018, while their return on average equity declined from 12.17% in 2017 to 10.83% for the year. The decrease in the banks' net profits mainly reflected the increase in the tax rates on profits and on interest income, as well as the impact of the double taxation. In fact, the banks' tax payments increased by US$ 393.4 million, or by 95% from US$ 414 million in 2017 to US$ 807.3 million in 2018, while the banks' pre-tax profits increased by 21.5% to US$ 3 billion in 2018. The banks' tax payments were equivalent to 26.5% of pre-tax profits in 2018 compared to a share of 15.2% in 2017.

GROUP ADDRESSES

BRANCHES ABROAD

Baghdad Branch, Iraq

Basra Branch, Iraq

Erbil Branch, Iraq

Sulaymaniyah Branch, Iraq

Limassol Branch, Cyprus

REPRESENTATIVE OFFICES ABROAD

Abu Dhabi Representative Office, United Arab Emirates

Nigeria Representative Office, Lagos, Nigeria

INSURANCE COMPANIES

ADIR Insurance and Reinsurance Co. S.A.L., Lebanon

ADIR Insurance and Reinsurance Co. Syria S.A., Syria

Adonis Brokerage House S.A.L., Lebanon

SUBSIDIARY BANK IN LEBANON

Byblos Invest Bank S.A.L.

SUBSIDIARY BANKS ABROAD

Byblos Bank Armenia C.J.S.C. with branches in Amiryan and Komitas

Byblos Bank Europe S.A. with branches in Belgium, France, and the United Kingdom

Please find the addresses of all overseas entities on the Contact Us page of the bank's website at www.byblobank.com

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