LEBANON ECONOMIC REPORT

ACUTE SLOWDOWN THOUGH STILL ESCAPING RECESSIONARY TRAP

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- Sluggish performance but still avoiding net contraction
  Real economic performance is sluggish on the overall this year but the economy is not contracting in real terms. According to the new IMF forecasts for 2012, real GDP growth would stand at 2% this year. The third quarter has witnessed a downturn in the domestic security situation following a series of kidnappings on the Lebanese territory. Though it ended on an improved note after the release of hostages and the Pope's visit to Lebanon, the summer touristic season was severely damaged.

- All real sector indicators actually confirming the slowdown
  Within the context of a wait and see attitude characterizing growth drivers, all real sector indicators reported a net contraction in value or a reduction in their growth rates. The quantity theory of money showed likewise a sluggishness in output, as the growth in Money Supply M3 by 5.8% on an annual basis over the first nine months of 2012 was more than offset by the reduction in velocity by 8.4% and the average inflation of 5% over the same period.

- Property sales transactions contracting but prices remain sticky on the downside
  The construction sector, at the image of the macroeconomy, continued to witness sluggishness this year and for the second year in a row. Its demand side slowed down as revealed by the 9% drop in property sales transactions, leading ultimately to a downward adjustment of the supply side as suggested by the downturn in new construction permits and cement deliveries (net contractions of 14.3% and 7.9% respectively). But prices remained relatively flat within the context of structural factors related to the quasi absence of speculation, low institutional and household leverage and scarcity of land.

- Jittery local environment marking tertiary sector activity
  The political uncertainties that prevailed throughout much of the year have affected the trade and services sector leading to a net contraction for some of its components and a slow growth for others. Indeed, weaker growth rates were seen within the airport's activity indicators while the value of cleared checks and the number of tourists reported a net contraction. As to the Port of Beirut, its relatively better activity could be more or less linked to the diverted merchandise from land routes affected by the situation in Syria.

- Pressures on foreign trade deficit generating large balance of payment shortfall
  A widening of 13.9% in the trade deficit over the first nine months of this year added to a similar expansion last year. Imports actually grew by 11.3% over the first nine months of 2012 while exports rose by a mere 2.2%, mainly due to the contraction in land exports amidst the security escalation in Syria. With the totality of inflows unable to fully offset the country's trade deficit, further pressures were reported on the balance of payments that recorded a deficit of US$ 1.9 billion in the first nine months of 2012, after a circa US$ 2 billion deficit in full-year 2011.

- Fiscal accounts back on the downside
  The public finance performance was afflicted this year by an overall economic slowdown and tense political conditions stalling reforms. Lebanon's fiscal balance moved deeper into the negative territory within the context of a rise in expenditures surpassing that of revenues. The IMF anticipates Lebanon's fiscal deficit to GDP ratio to reach 7.9% in 2012, reversing the downward streak the country had been witnessing since 2007. In parallel, the country's gross debt reached US$ 56.0 billion at end-September 2012, accounting for circa 136% of GDP, still one of the highest ratios in the emerging countries arena.

- Moderate year-to-date banking activity growth amid tough operating conditions
  Lebanese banks witnessed a moderate yet slower activity growth over the first nine months of 2012, amid persistently tough operating conditions characterized by tight interest margins, downward pressures on fee income and within the context of domestic political tensions and deteriorated security conditions in some neighboring countries. Banks' total activity, measured by the aggregated domestic assets of Lebanese banks, grew by 5.5% in first nine months of 2012 to reach US$ 148.4 billion at end-September 2012, the equivalent of 350% of Lebanon's GDP.

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The Lebanese economy has reported a sluggish performance in the first nine months of 2012 though it continued to avoid net contraction. According to the new IMF forecasts, real GDP growth would stand at 2% this year. The third quarter has witnessed a downturn in the domestic security situation following a series of kidnappings on the Lebanese territory. Though it ended on an improved note after the release of hostages and the Pope's visit to Lebanon, the summer touristic season was severely damaged.

All real sector indicators actually confirm the slowdown within the context of a wait and see attitude characterizing both domestic and external growth drivers of the economy. The quantity theory of money showed a sluggishness in output, as the growth in Money Supply M3 by 5.8% on an annual basis over the first nine months of 2012 was more than offset by the reduction in velocity by 8.4% and the average inflation of 5% over the same period despite the increase in wages this year. Domestic consumption still continues to report a "relative" resilience, as witnessed by the double-digit growth in the imports of consumption products over the first nine months of 2012. In parallel, a wait-and-see attitude is delaying major investment decisions. At the mirror image of such demand, imports of investment goods reported a nominal standstill over the first nine months of 2012 (turning into negative growth in real terms).

At the external sector level, a widening of 13.9% in the trade deficit over the first nine months of 2012 added to a similar expansion last year. Imports actually grew by 11.3% over the first nine months of 2012 relative to last year's corresponding period while exports rose by a mere 2.2%, mainly due to the contraction in land exports amidst the security escalation in Syria. Tourism has been adversely affected by the security incidents and the GCC warnings to their nationals and the retreat of land visitors through Syria, with the total number of tourists declining by 14.9% over the first nine months, while the number of incoming passengers at the Beirut Airport managed to rise by 5.0% over the same period driven mainly by the significant incoming of Lebanese expatriates. With the totality of inflows unable to fully offset the country's trade deficit, further pressures were reported on the balance of payments that recorded a deficit of US$ 1,932 million in the first nine months of 2012, after a circa US$ 2 billion deficit in full-year 2011.

At the monetary level, the foreign exchange market was favorable at all times despite uncertainties. Activity was more to the favor of the Lebanese Pound year-to-date, as there were more conversions from foreign currencies to Lebanese Pounds than the opposite since the beginning of the year, with net conversions to the national currency estimated at a positive level of above US$ 1.5 billion. This helped raising the foreign assets of the Central Bank to a record high of US$ 35.1 billion, the equivalent of as high as 84% of Money Supply in Lebanese Pounds. The coverage ratio actually goes up to 123% when accounting for US$ 16.4 billion of gold reserves, thus corresponding to a full currency board situation.

Lebanon's banking activity witnessed a relative slowdown as well, with bank deposits growing by US$ 6.0 billion in the first nine months of 2012, 2% less than the growth of the past year's similar period and 26% less than the average growth of the similar nine-month period of the previous 5 years. Bank loans have likewise seen a slowdown in their year-to-date growth reaching US$ 2.9 billion, or 24% less than growth in the corresponding period of 2011. The growth in LP deposits accounted for 57% of total deposit growth while FX deposits accounted for the remaining 43%, contracting deposits dollarization by 1.1% from 65.9% in December 2011 to 64.8% in September 2012. Banks operating conditions continue to be tough amidst an atypical domestic and external operating environment characterized by pressures on spreads and margins, slow fee income growth generation and growing provision requirements as a precautionary measure facing regional developments' spillovers. Lebanon's banking sector reported an 8% growth in domestic net profits over the first 8 months of 2012, after the net contraction of last year.

At the capital markets level, more pressures were witnessed this year. Over the first nine months, the Stock market index retreated by 4.7%, marking the third consecutive year of price contraction. This comes within the context of a low trading volume, with annual trading value standing at 4.6% of market capitalization. The further contraction in prices lead to significantly low valuation ratios, with the market's Price to Earnings standing at 6.8 times and the Price to Net asset value standing at 1.1 times, well below regional and global benchmarks. In parallel, the fixed income market saw some volatility with the average spread on bonds outstanding expanding by 12 basis points to reach 333 basis points by end-September.

The detailed developments in the real sector, external sector, public sector and financial sector will be analyzed thereafter. The concluding notes are given to the prospects of softlanding in Lebanon's economy and its public finances in the assumption of gas extraction in due time.

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture and Industry

Mixed performance in the primary and secondary sectors

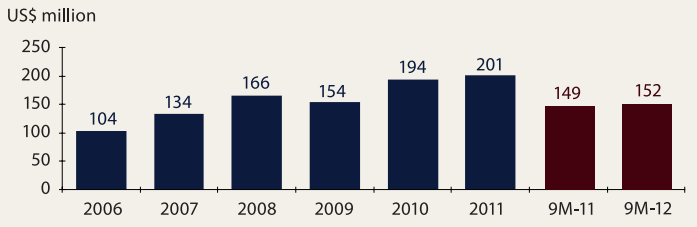
The primary and secondary sectors of the economy have been reporting mixed performances but their activity remains somehow sluggish on the overall. Whereas the agricultural sector continues to show a weak performance on its internal side, within the context of a diminishing local demand on account of some security concerns, the external component of the sector registered some signs of improvement as it was boosted by a ministerial decision to export agricultural products through maritime routes bypassing transport through the borders with Syria.

Improved performance on the external side in the third quarter of 2012 raised the total of agricultural exports for the first nine months of 2012 by 2.0% year-on-year to reach US$ 152 million. Regarding the internal component of the sector, the cost of Lebanon's imported agricultural products registered a decrease of 2.6% but remains high at US$ 1.38 billion when compared to the value of agricultural exports during the said period of 2012. Within the context of a declining internal demand coupled with a higher value of exports, the agricultural trade deficit has slightly tightened by 3.1% to reach US$ 1.23 billion in the first nine months of 2012. Regarding the financing of the sector, bank loans to Lebanese agriculture maintained a minimal share of less than 1% of the total. Also, the number of Kafalat guarantees allocated to SMEs specializing in the agricultural sector came consistent with last year's downward trend to register a net decline of 24.6%. Hence the share of the agricultural sector from the total number of Kafalat's promoted loans decreased from 41.0% in the first nine months of 2011 to 37.5% in the same period of 2012.

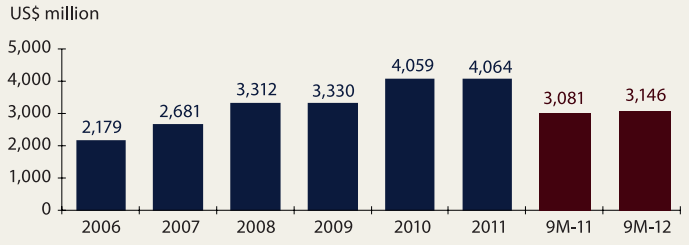
Regarding the industrial sector, it has likewise registered a modest performance in its internal and external components. Industrial exports amounted to US$ 3.1 billion in the first nine months of 2012, up by 2.1% from the same period of last year. When it comes to the imports of industrial machinery, they reached US$ 210.4 million during the first eight months of 2012, up by 26.3% from the same period of 2011. The breakdown of industrial machinery by country of origin shows that the bulk comes from Italy (23.6%), China (16.8%), and Germany (12.1%). Apparently, investors are becoming less deterred by the surrounding security conditions and more prone to taking risks and initiating new projects, as reflected by the increased demand for industrial machinery. Looking at the number of Kafalat guarantees allocated for the industrial sector in the first nine months of 2012, they have maintained almost the same share of the total Kafalat loans at around 38%. The number of Kafalat loans to the sector, however, decreased by 17.3% to reach a total of 307.

In a nutshell, activity within the primary and secondary sectors showed mixed results despite some positive marks in the last quarter mirrored by improved agricultural exports and increased imports of industrial machinery. Retreated local consumption continues to weigh down on imports of agricultural products, whereas exports of both agricultural and industrial goods remain vulnerable to the regional unrest affecting the export procedure through border lines.

AGRICULTURAL EXPORTS



INDUSTRIAL EXPORTS



1.1.2. Construction

Prices sticky on the downside in a flattening phase

The construction sector, at the mirror image of the macroeconomy, continued to witness sluggishness this year and for the second year in a row. Its demand side slowed down relatively, as revealed by the number of property sales transactions, leading ultimately to a downward adjustment of the supply side as suggested by the downturn in new construction permits and cement deliveries.

This year's slowing down performance is emphasized through the number of property sales transactions which contracted by 9.2%. In parallel, statistics showing a drop in both built and unbuilt realty sales volume, reflect that the correction in sales activity from the high base of the booming years is affecting both the land and apartment components of the Lebanese real estate sector. Still, figures published on the value of transactions show that the market improved slowly from the sluggish performance registered last year. In details, the value of real estate sales increased by 4.8% year-on-year to reach US$ 6.3 billion in the first nine months of 2012. It is important to note, however, that such an increase is not that major as it stems from a low base registered in 2011, and remains below the figures recorded in the years 2009 and 2010.

A breakdown of transactions by regions shows that most of the regions have registered a year-on-year increase in the value of transactions registered in the first nine months of 2012. Among those, Beirut recorded the slightest increase of 1.5% reflecting the inclination of buyers towards relatively less expensive areas where prices are more consistent with their purchasing power on the overall.

The supply side of the construction activity is slowing down in tandem with the sluggish demand. Indeed, the flat performance of the market prompted developers to take more time to launch their new projects. Construction costs, on the other hand, have been on a downward path this year, after moderate single-digit growth in the past two years.

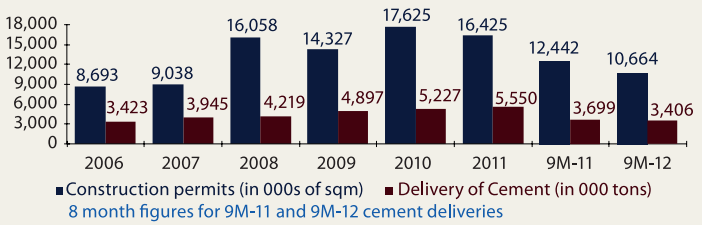
Figures released by the Order of Engineers in Beirut and Tripoli show that the area of newly issued construction permits registered a slowdown of 14.3% in the first nine months of 2012 relative to the same period of last year with most regions posting year-on-year contractions. Likewise, cement deliveries, an indicator of ongoing projects, showed a decline of 7.9% in the first eight months of 2012. It is important to highlight that due to the role it has in providing holiday homes to tourists and Lebanese Diaspora, construction activity has been affected by the sluggish performance of the tourism sector, as the latter is being deterred by the unrest in Syria.

Last but not least, the downward correction in the overall property market size was not accompanied by a similar contraction in prices. Indeed, prices remained relatively flat within the context of the flattening phase initiated since the end of 2010. Structural factors related to the quasi absence of speculation, low institutional and household leverage and scarcity of land continue to support property prices in Lebanon that are almost sticky on the downside.

CONSTRUCTION

	Q3-11	9M-11	Q3-12	9M-12	Variation Q3/Q3	Variation 9M/9M
Value of property sales (in millions of US$)	2,182	6,032	2,170	6,320	-0.5%	4.8%
Number of property sales	20,590	57,976	18,233	52,621	-11.4%	-9.2%
o.w. Sales to foreigners	371	968	340	990	-8.4%	2.3%
Average value per property sale (US$ 000)	106	104	119	120	12.3%	15.4%
Property taxes (in millions of US$)	145	422	145	439	-0.5%	4.1%

EVOLUTION OF CONSTRUCTION INDICATORS



8 month figures for 9M-11 and 9M-12 cement deliveries

1.1.3. Trade and Services

Jittery local environment marks tertiary activity

The political uncertainties that prevailed throughout much of the year have affected the trade and services sector leading to a net contraction for some of its components and a slow growth for others. Indeed, weaker growth rates were seen within the airport's activity indicators while the value of cleared checks and the number of tourists reported a net contraction. As to the Port of Beirut, its relatively better activity could be more or less linked to the diverted merchandise from routes affected by the situation in Syria.

With regards to Lebanon's tourism sector, it posted a hastened decline in arrivals during the first nine months of 2012 within the context of the sporadic events that have been occurring so far this year compounded by the ongoing impact of regional developments. Indeed, the double-digit drop of the number of tourists reached 14.9% to reach 1,086 thousand tourists during the first nine months of 2012. Such a trend is partly tied to the significant drop seen in September 2012, month during which the number of tourists retreated by 33.3%, the most significant annual decline since the beginning of the year. Most notably, the number of incoming Arabs edged down by 15.0% year-on-year as they were hesitant to visit the country subsequent to the travel warning issued by their governments in mid-May 2012, not to mention the influence that regional developments had on land travel.

As to the airport activity, the latest statistics published by the Rafic Hariri International Airport showed that the number of arriving passengers increased by 5.0% year-on-year to reach 2,229 thousand passengers in the first nine months of 2012. Such a growth rate has been slowing down since the first quarter of the year with arrivals mainly limited to Lebanese expatriates while those of Arab origin have relatively scaled back their visits. Also, it is worth mentioning that the number of arriving passengers has again shifted to an annual decline of 7.3% during the month of September 2012. In parallel, the number of landing aircrafts is also on an ongoing slowdown and reported a mere increase of 0.3% year-on-year to reach 24,052 planes during the first nine months of 2012 while posting a decline of 8.7% year-on-year during the month of September 2012.

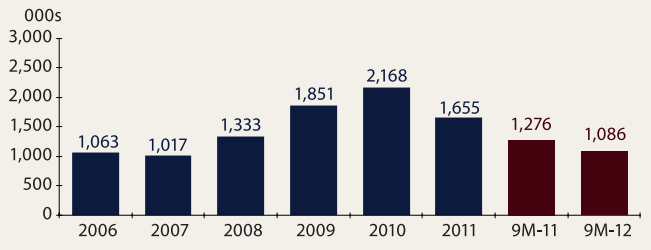
Pertaining to the Port of Beirut, indicator of maritime transport which handles the bulk of foreign trade services, its activity was mostly on an upward path somewhat attributed to diverted trade activity from other disturbed routes. Regardless of the decline in the number of transshipments (-3.2% year-on-year) and vessels using the Port (-3.8% year-on-year), the tonnage of loaded and unloaded merchandise went up by 6.3% annually to reach 5,340 thousand tons during the first nine months of 2012. The number of containers handled by the Port (excluding transshipments) rose by 8.7% on a yearly basis to attain 477,279 containers during the aforementioned period of this year. As to revenues generated by the Port, they reached their highest level since the same period of 2004 to post a total US$ 128.7 million, depicting an 8.0% annual increase.

Finally, the value of cleared checks showed a slowdown in spending dynamics. Total cleared checks, most of which reflect investment-related spending, amounted to US$ 52,965 million in the first nine months of 2012, down by a slight 1.4%. The value of cleared checks by quarter has been reporting consecutive slowdowns since the beginning of the year with that of the first three months rising by a slight 2.3%, that of the second quarter by 1.6% and that of the third quarter contracting by 7.3%.

TRADE AND SERVICES

					Variation	
	Q3-11	9M-11	Q3-12	9M-12	Q3/Q3	9M/9M
Number of ships at the port	561	1,648	574	1,586	2.3%	-3.8%
Number of containers at the port (in 000s)	150	439	172	477	14.8%	8.7%
Merchandise at the Port (in 000 tons)	1,780	5,025	1,855	5,340	4.2%	6.3%
Planes at the Airport	18,376	47,977	17,507	48,101	-4.7%	0.3%
Number of passengers at the Airport (excluding transit)	1,843,354	4,244,226	1,808,451	4,537,661	-1.9%	6.9%
Cleared checks (in millions of US$)	19,603	53,735	18,163	52,965	-7.3%	-1.4%

EVOLUTION OF THE NUMBER OF TOURISTS



1.2. EXTERNAL SECTOR

Political and economic conditions play havoc with Lebanon's external accounts

Dimmed economic activity, coupled with a state of frail local and regional politico-security conditions, have left Lebanon's external sector in a somewhat weak position to reap spillovers arising from the Arab Spring or even the challenging global backdrop as happened in 2009. As a matter of fact, figures released by the Higher Customs Council covering the first nine months of 2012 showed that Lebanon's trade deficit widened by 13.9% year-on-year to reach US$ 12.7 billion. The increase has indeed eased from previous periods of 2012, but this stems mainly from a weaker rise in imports on account of a relatively slower local demand and not a pick-up of exports.

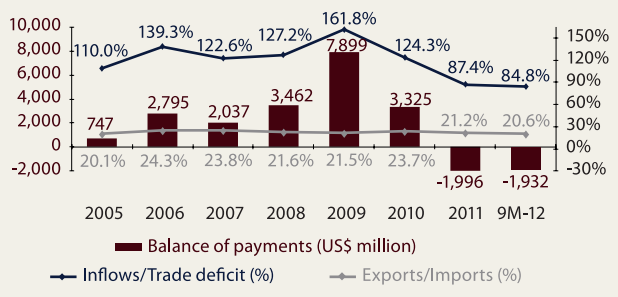
In details, exports actually grew by 2.2% annually, moving from US$ 3.2 billion in the first nine months of 2011 to US$ 3.3 billion in the same period of this year. While exports through Aboudieh, Masnaa, Arida and Kaa are still on a downward path (-6.6% year-on-year), those through the Airport and the Port of Beirut, which both handle the bulk of outgoing merchandise, reported an annual rise of 11.9% and 1.9% respectively, during the first nine months of 2012. The increase in exports was also mainly tied to jewelry which account for circa 40% of the total and reported a 16.1% year-on-year increase.

A breakdown by country shows that Lebanon's main export markets during the first nine months of 2012 came as follows: Switzerland (11.8% of the total), KSA and UAE (8.2% each), Syria (5.9%) and Iraq (4.5%). Exports to Syria reported an increase of 29.3% year-on-year as the country has been witnessing a need of essential commodities which is partially met by Lebanese products.

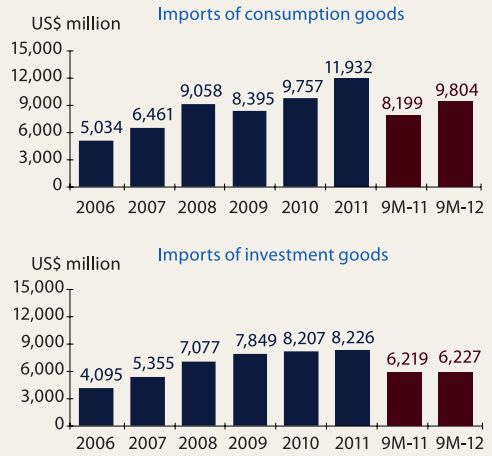
In parallel, imports went up by 11.3% over the period, moving from US$ 14.4 billion in the first nine months of 2011 to US$ 16.0 billion in the same period of this year. While incoming merchandise is still managing to report an increase, its trend has been on a downward path since the first two months of 2012, thus revealing a local demand, be it for consumption or investment purposes, relatively impacted by the sporadic developments that Lebanon has been subjected to mainly since the month of May 2012. The breakdown of imports by country of origin shows that most of the inward merchandise during the first nine months of the year came from the US with 13.0% of the total, followed by China with 8.1% of the total, Italy with 7.9%, and France with 7.3% of total imports.

While the trade balance is running a large deficit, it is generally offset by significant financial inflows ranging from remittances to tourist receipts and foreign direct investments. However, financial inflows, which totaled US$ 10.8 billion during the first nine months of 2012 (+12.1% year-on-year), remained insufficient to counterbalance the fast growing trade deficit. This left the balance of payments with a shortfall of US$ 1.9 billion during the first nine months of 2012, versus another balance of payment deficit of US$ 1.5 billion in the same period of 2011.

FOREIGN SECTOR INDICATORS



IMPORTS OF CONSUMPTION AND INVESTMENT GOODS



1.3. PUBLIC SECTOR

Fiscal accounts back on the downside

The public finance performance was afflicted this year by an overall economic slowdown and tense political conditions stalling reforms though also somewhat containing fiscal expenditures. Lebanon's fiscal balance moved deeper into the negative territory within the context of a rise in expenditures surpassing that of revenues. Public spending went up by 10.7% on an annual basis while revenues increased at a slower pace of 5.7% during the first seven months of 2012 (last available figures). Consequently, Lebanon's fiscal deficit widened by 46.4% year-on-year to reach US$ 1,169 million. As to the primary surplus, which excludes debt service, it totaled US$ 931 million (13.0% of total expenditures), lower by 34.9% than during the first seven months of 2011.

Total expenditures amounted to US$ 7,152 million, of which nearly 83% was allocated to budget expenditures, while the rest went into treasury expenditures. In details, budget expenditures declined by 1.6% year-on-year to reach US$ 5,934 million in the first seven months of 2012. Most of the total was allocated to the general expenditures with those related to the national electricity company making up the bulk of the latter category, rising by 63% to reach US$ 1,238 million. Interest payments recorded a decrease of 5.4% year-on-year to reach US$ 1,994 million, noting that both domestic and foreign debt servicing declined from the first seven months of 2011. Foreign debt principal repayment edged down by 12.3% over the aforementioned period of 2012 to attain US$ 106 million. Treasury expenditures rose by more than three folds on a yearly basis to hit a total of US$ 1,218 million mainly boosted by miscellaneous Treasury expenditures as well as withdrawals on municipalities. On the revenues side, those classified under budget transactions increased by 6.4% to US$ 5,715 million, of which 77% originated from tax revenues and 23% from non-tax revenues. In details, tax revenues increased by 8.1% year-on-year to reach US$ 4,425 million in the first seven months of 2012. Miscellaneous taxes rose by 10.6% while VAT revenues increased by 7.0% annually to attain US$ 2,151 million and US$ 1,404 million, respectively. With regards to non-tax revenues, they have taken into account a total of US$ 836 million coming from the Ministry of Telecommunications and totaled US$ 1,290 million on the overall.

While awaiting the discussion of the 2012 budget by Parliament, the Ministry of Finance submitted the 2013 draft budget in September 2012 which envisages a deficit narrowing by 15.7% helped by revenues from planned new taxes. The budget envisages spending of US$ 15.3 billion, an increase of 9.5% over the 2012 budget, which was only approved by the cabinet in July. The budget projects revenue at US$ 12.2 billion, a 20% rise over the previous year, thereby anticipating a deficit of US$ 3.1 billion. Around US$ 2.4 billion of total revenues would stem from new taxes with the proposal among which an increase in VAT from 10% to 12%.

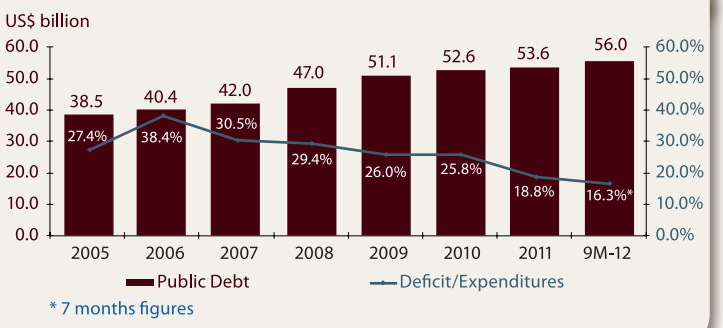
Overall, important fiscal imbalances still prevail with relatively high indebtedness ratios, requiring fiscal consolidation and public sector reforms. The IMF anticipates Lebanon's fiscal deficit to GDP ratio to reach 7.9% in 2012 and a wider 8.3% in 2013, reversing the downward streak the country had been witnessing since 2007 on account of bullish economic performance, and putting pressure on the country's indebtedness ratio. As a matter of fact, the country gross debt reached US$ 56.0 billion at end-September 2012, accounting for circa 136% of GDP, still one of the highest ratios in the emerging countries arena.

PUBLIC SECTOR

in millions of US$

Deficit financing	7M11 Vol	7M12 Vol	Progression Vol
Deficit	798	1,169	371
State creditor accounts	-270	878	1,148
Other items	-316	-259	57
Uses=sources	**212**	**1,788**	**1,575**
LP	**24**	**-285**	**-308**
Treasury bills (banking system)	36	-499	-535
Others	-13	214	227
FX	**188**	**2,072**	**1,884**
Sovereign eurobonds (including Paris II bonds)	116	2,073	1,957
Others	72	-1	-73

PUBLIC INDEBTEDNESS



* 7 months figures

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Conversion activity to the benefit of the Lebanese Pound despite uncertainties

Lebanon's monetary conditions were marked over the first nine months of 2012 by an expansion in money supply, net conversions in favor of the Lebanese Pound, growth in BDL's foreign assets and new LP Treasury bills issuances.

In details, the foreign exchange market saw net conversions in favor of the Lebanese Pound during the first nine months of 2012 despite local uncertainties and concerns about the repercussions of the security developments in neighboring countries on the local front. The relatively favorable activity on the FX market was coupled with the swapping of the equivalent of US$ 2 billion of LP Treasury bills held by the Central Bank of Lebanon into new Eurobonds issued by the Treasury in June 2012. This enabled the BDL to reinforce its foreign assets to hit US$ 35.1 billion at end-September 2012, up by US$ 2.9 billion since year-end 2011, noting that the said rise compared to a lower growth of US$ 1.5 billion during the corresponding period of 2011. Accordingly, BDL's foreign assets covered 83.9% of LP money supply and 19.7 months of imports at end-September 2012, which spots light on the Central Bank's strong ability to defend the currency peg and meet demand for foreign currencies, should any pressures arise.

Mainly driven by FC-to-LP conversions and the substantial growth in LP net claims on the public sector during the first nine months of 2012, LP money supply expanded by LP 4,381 billion (the equivalent of US$ 2,906 million). This compares to a contraction of LP 2,596 billion during the corresponding period of 2011 (the equivalent of US$ 1,722 million). The rise in LP money supply during the first nine months of 2012 resulted mainly from a surge in LP saving deposits of LP 4,200 billion (the equivalent of US$ 2,786 million).

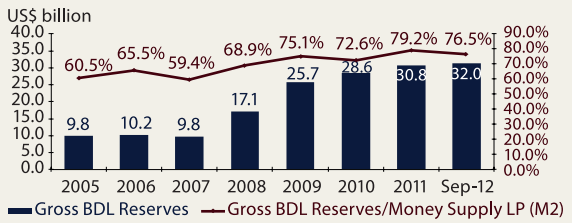
When adding foreign currency deposits, Money Supply in its broad sense (M3) grew by US$ 4,266 million or 4.4% during the first nine months of 2012. This money supply growth compares to a money creation of US$ 2,297 million during the said period that resulted from an increase of US$ 2,612 million in net bank lending to the private sector and from a US$ 1,725 million rise in the State's indebtedness towards the banking system (excluding valuation adjustments), within the context of a negative change in net foreign assets (excluding gold) of US$ 2,040 million. The US$ 1,969 million difference between the growth in money supply and money creation corresponds to a monetization of financial claims during the first nine months of 2012.

The LP Treasury bills portfolio held by the public increased by US$ 195 million during the first nine months of 2012 to reach US$ 5,362 million at end-September 2012 as compared to a contraction of US$ 72 million during the corresponding period of the previous year, within the context of net conversions in favor of the Lebanese Pound and a 50 bps rise in LP interest rates across the board in March 2012. Yet, as a measure of disintermediation, the share of LP Tbs held by the public to LP Money Supply (M2) went down from 13.3% at end-2011 to 12.8% at end-September 2012. As for crowding out effects, the share of the State in bank credits fell from 46.1% at end-2011 to 44.8% at end-September 2012, which underlines a growing bank interest in lending to the private sector.

MONETARY SITUATION

Flows in US$ million	9M-11 Vol	9M-12 Vol	Progression Vol
Net foreign assets (excluding gold)	-1,441	-2,040	-599
Net claims on the public sector (excluding valuation adjustments)	687	1,725	1,038
Claims on the private sector	3,008	2,612	-396
Uses=Sources	**2,254**	**2,297**	**43**
Money (M3)	3,481	4,266	785
Valuation adjustment and other items	-1,227	-1,969	-742

EXCHANGE MARKET INDICATORS



1.4.2. Banking Activity

Moderate year-to-date activity growth amid tough operating conditions

Lebanese banks witnessed a moderate yet slower activity growth over the first nine months of 2012, amid persistently tough operating conditions characterized by tight interest margins, downward pressures on fee income and within the context of domestic political tensions and deteriorated security conditions in some neighboring countries. Banks' total activity, measured by the aggregated domestic assets of Lebanese banks, grew by 5.5% in first nine months of 2012, moving from US$ 140.6 billion at end-December 2011 to US$ 148.4 billion at end-September 2012. This compares to relatively higher growth rates of 7.4% in the corresponding 2011 period and 11.1% over the previous five years' similar period.

Total deposits continue to constitute the main engine of growth for Lebanese banks, accounting for 82% of total balance sheet, comparing quite favorably to regional and international benchmarks and providing banks with a stable and sticky funding base. Banking sector deposits grew by an additional US$ 6.0 billion over this year's first nine months to reach US$ 121.8 billion at end-September, i.e a moderate 5.2% increase. While the volume growth realized this year is pretty much in line with that of the corresponding 2011 period, which was also characterized by a relatively tough environment, it turned out to be 26% lower than the average deposit growth registered over the previous five years' first nine month period.

The continuous deposit base increase so far in 2012 was mostly attributed to a rise in funds from residents, which accounted for 72% of the total volume growth, more or less maintaining its 2011 share. Non-resident deposits, which represent slightly less than 19% of the total deposit base in the country, grew by US$ 1.7 billion over the first nine months of 2012, accounting for the remaining 28% of the total deposit increase.

The breakdown of banks' deposits by currency shows that local currency deposits took the lion's share in total volume growth this year, with US$ 3.4 billion or a 57% share. This reflects overall balanced activity on the foreign exchange market and the absence of significant long-lasting currency pressures despite the occasional domestic security drifts and political bickering. Foreign currency deposits progressed by a lower US$ 2.6 billion over the first nine months, which brought the deposit dollarization ratio slightly down from 65.9% at year-end 2011 to a near two-year low of 64.8% at end-September 2012.

Lebanese banks thus continue to remain highly liquid, with close to half their deposits covered by primary liquidity, i.e. placements at the Central Bank or banks abroad. This is not only noticeably higher than global benchmarks, but also provides Lebanese banks with sufficient room to extend new waves of credit to the economy despite the tough operating conditions. Such a fact is further compounded by banks' low leverage and high financial flexibility, as reflected by its loan-to-deposit ratio of less than 35%. Within this context, bank loans to the private sector progressed by 7.4% since the beginning of 2012 to attain a new

BANKING ACTIVITY

in US$ million	2010	2011	2011				2012				Variation	
			Q1	Q2	Q3	9M	Q1	Q2	Q3	9M	Q3/Q3	9M/9M
Var: Total assets	13,675	11,651	3,562	2,942	2,993	9,497	4,151	1,170	2,463	7,784	-17.7%	-18.0%
% change in assets	11.9%	9.0%	2.8%	2.2%	2.2%	7.4%	3.0%	0.8%	1.7%	5.5%	-0.5%	-1.9%
Var: Total deposits	11,437	8,511	941	3,337	1,910	6,188	2,509	1,660	1,869	6,037	-2.1%	-2.4%
o.w. LP deposits	5,373	23	-2,491	131	1,215	-1,145	1,497	1,037	913	3,447	-24.9%	-401.0%
o.w. FC deposits	6,065	8,487	3,433	3,206	694	7,333	1,012	623	956	2,590	37.8%	-64.7%
% change in total deposits	11.9%	7.9%	0.9%	3.1%	1.7%	5.8%	2.2%	1.4%	1.6%	5.2%	-0.2%	-0.6%
Var: Total credits	6,555	4,446	1,504	822	1,506	3,832	1,622	707	587	2,916	-61.0%	-23.9%
o.w. LP credits	2,351	1,618	308	530	401	1,239	338	308	376	1,022	-6.2%	-17.5%
o.w. FC credits	4,204	2,827	1,196	292	1,105	2,593	1,283	398	212	1,893	-80.8%	-27.0%
% change in total credits	23.1%	12.7%	4.3%	2.3%	4.0%	11.0%	4.1%	1.7%	1.4%	7.4%	-2.6%	-3.6%

high of US$ 42.3 billion at end-September 2012, thus providing further support to the domestic economy, although the US$ 2.9 billion loan growth proved 24% lower than that of the 2011 similar period.

Bank loans were largely targeted at the resident sector this year, with the latter getting 93% of total new loans. It seems that loans booked in Lebanon and extended to non-residents have still not renewed with their pre-Arab Spring levels. From a currency perspective, loans extended in foreign currencies continued to account for the bulk of the total growth in lending (around two thirds). Still, Lebanese Pound denominated loans accounted for a sizeable 35% of total new lending volumes, partly favored by the supportive BDL policies in this respect adopted a couple of years ago.

Banks in Lebanon also continued to ameliorate their sovereign risk profile, with declining exposure to the State since the beginning of the year. Though remaining relatively high, the ratio of banks' foreign currency sovereign bond portfolio to their equity base stood at 108.0% at end-September 2012, against 118.2% at end-December 2011 and levels above the 200% mark a few years ago. Also, the ratio of banks' foreign currency sovereign bond portfolio to their foreign currency deposit base reached 16.3% at end-September 2012, slightly down from 16.6% at end-2011 and levels above the 20% mark a few years back.

Last but not least, and at the level of profitability, Lebanese banks continue to face a tight spread environment. While the spread in foreign currencies has slightly increased this year as a result of higher lending rates, the spread in Lebanese Pound has continued to decline, given that the recent increase in LP Tbs rates did not manage to counterbalance the renewal of Tbs at rates lower than initial subscriptions. This adds to slower fee income generation and growing provisioning requirements within the context of regional security developments, constituting downward pressures on banks' revenue base. On the overall, the sector reported an aggregated 8% increase in domestic net profits on a yearly basis over the first eight months of 2012, as per the latest statistics available. It is yet worth noting that when excluding profits from discontinued operations realized by a large bank, the bottom line growth rate would drop by more than half its reported level.

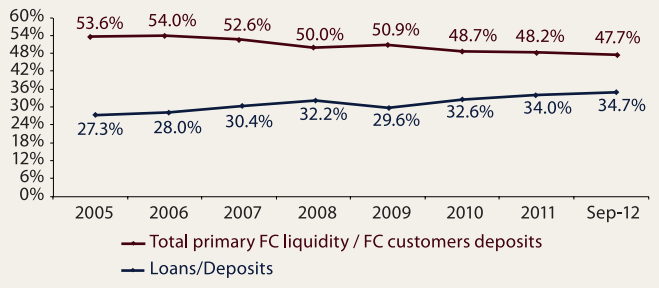
1.4.3. Equity and Bond Markets

Mixed price movements in Lebanese capital markets

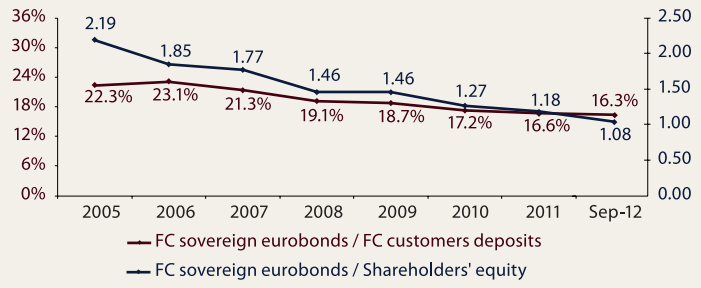
Lebanon's capital markets saw mixed price movements during the first nine months of the year 2012, with the equity market posting drops in share prices and the bond market recording small rises in prices and contractions in the cost of insuring debt despite local political concerns and worries about the spillover effects of security developments in neighboring countries on the local scene.

The Eurobond market saw two-way flows during the first nine months of 2012. In fact, some foreign market players offered their papers on concerns about the local political situation and the repercussions of the security developments in neighboring countries, while some other foreign investors showed

BANKS LIQUIDITY STANDING



BANKS SOVEREIGN EXPOSURE



demand for Lebanese debt papers during the third quarter of the year in line with demand for regional debt papers that are deemed safe-haven investments amid Europe's debt woes and as foreign investors underweight Lebanon in their portfolios. In parallel, Lebanese banks that hold 70% of the Eurobond portfolio absorbed the foreign offer during the first nine months of the year on the basis of a high foreign currency primary liquidity estimated at US$ 37.6 billion at end-September 2012, yet they started to offer their papers towards the end of the third quarter, leaving room for the forthcoming bond issue. Under these conditions, the Lebanese average yield decreased moderately by 20 basis points during the first nine months of 2012 to reach 4.22% at end-September 2012. The average bond spread expanded by 12 bps to reach 333 bps due to a relatively higher decline in international benchmark yields than Lebanese yields. Lebanon's five-year Credit Default Swap spread, which is a measure of market risk perception, contracted by 14 bps during the first nine months of 2012 to reach 458 bps at end-September, standing well below its high levels reached mid-year due to adverse security developments in neighboring countries.

After issuing a 5.5-year US$ 600 million bond in March 2012 and tapping an existing bond maturing on November 27, 2026 through the issuance of a US$ 350 million bond, Lebanon's Ministry of Finance has recently hired Credit Suisse, BLOM Bank and Byblos Bank for a Eurobond issue that could be worth up to US$ 2 billion. Lebanon may exchange US$ 1.5 billion in outstanding bonds maturing in 2013 for the new notes and may issue additional bonds in exchange for cash. The Eurobond portfolio stood at US$ 19,118 million at end-September 2012 after the redemption of three bonds totaling US$ 683 million.

In parallel, local political uncertainties and concerns about the security developments in neighboring countries triggered some selling operations on the Beirut Stock Exchange and held back market players from adding new positions despite favorable fundamentals that highlight the attractiveness of Lebanese stocks relative to regional peers. In fact, the BSE traded at a weighted P/E ratio of 6.8x at end-September 2012 as compared to a P/E of 12.1x in the MENA region. In parallel, it reported a P/NAV ratio of 1.10x, versus 1.55x in the region. Despite these attractive valuations, the BSE price index dropped by 4.7% during the first nine months of 2012, mainly undermined by the general level of uncertainties. This led to a fall in the BSE market capitalization from US$ 9,892 million at end-2011 to US$ 9,661 million at end-September 2012. As to market volatility, it is worth mentioning that the BSE volatility measured by standard deviation of share prices to the mean of prices, recorded 2.4% during the first nine months of 2012, as compared to 5.3% in other emerging markets and 4.1% in other Arabian markets.

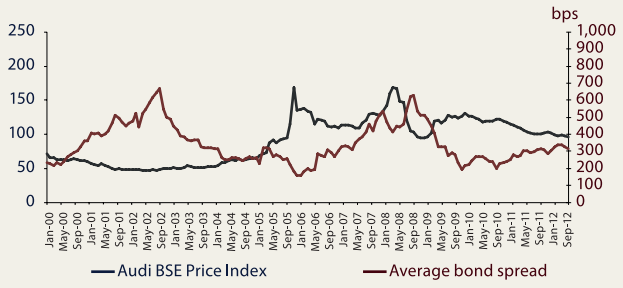
The total trading value amounted to US$ 333 million during the first nine months of 2012 as compared to US$ 444 million during the corresponding period of 2011. The total turnover ratio, measured by the annualized trading value to market capitalization, reached 4.6% during the first nine months of 2012 against 5.8% during the corresponding period of 2011, which spots light on the slowdown in activity on the BSE due to lower investor appetite for Lebanese stocks amid concerns about political and security drifts.

FINANCIAL SECTOR (NON-BANKS)

	2007	2008	2009	2010	2011	9M-12
Beirut Stock Exchange						
Market capitalization (in millions of US$)	11,977	9,323	11,982	11,893	9,892	9,661
Total trading volume (in millions of US$)	925	1,659	943	820	513	333
Annual trading volume/Market capitalization	7.7%	17.8%	7.9%	6.9%	5.2%	4.6%
Price index	149.1	115.8	144.0	137.7	110.4	105.2
% change in index	21.4%	-22.3%	27.3%	-4.4%	-19.8%	-4.7%
P/E ratio*	13.01	8.97	10.19	8.82	6.92	6.80
P/NAV ratio*	1.76	1.47	1.51	1.43	1.12	1.10
Lebanese Eurobonds						
Total volume (in millions of US$)	16,965	17,178	17,704	17,736	18,954	19,118
Average yield	8.1%	8.7%	5.3%	4.1%	4.4%	4.2%
Average spread (bps)	458	727	290	182	321	333
Average life (in number of years)	4.8	4.6	4.6	4.7	5.5	5.2

* for large listed banks

CAPITAL MARKETS PERFORMANCE



2. CONCLUSION: COULD GAS EXTRACTION PROVIDE A LONG TERM SOFTLANDING TO LEBANON'S PUBLIC FINANCES?

Lebanon's most critical issue remains that of its public finances, with a debt to GDP ratio revolving around 135% and a deficit to GDP ratio of more than 7% for 2012, quite elevated by current international benchmarks despite the net improvement of the second half of the past decade. In the absence of structural reforms or an era of buoyant economic growth, such ratios are set to deteriorate further or in the best case scenario maintain their actual levels. Among possible softlanding scenarios rises the potential gas extraction at its Southern coasts, which, if materializing, is set to put an end to Lebanon's ongoing fiscal challenges.

A British based foreign company, Spectrum and Petroleum Geo-services, had conducted a survey of Lebanon's offshore and land petroleum and gas resources, showing that the country enjoys a wealth exceeding previous estimates. The Spectrum company had unveiled its findings during a conference in London, confirming that Lebanon's oil and gas wealth off its southern coast is among the richest and best in the neighboring region. Lebanon has been considered relatively slow to exploit such maritime resources compared with other eastern Mediterranean countries, namely Cyprus, Turkey and Israel.

In August of last year, parliament passed a law setting the country's maritime boundary and Exclusive Economic Zone in which it has special rights to explore and exploit natural resources. In June of this year, Lebanon was able to restore 530 square kilometers of a maritime area that it considered to be within its Exclusive Economic Zone. Lebanon and Israel are actually bickering over a zone that consists of about 854 square kilometers of suspected energy reserves. By beginning November, the European Investment Bank and the French Development Agency were interested in funding natural gas pipelines in Lebanon. So far, 26 international companies have bought surveys of Lebanon's offshore area that will be shared between Spectrum and the Lebanese State. By the time of the finalization of this report, government efforts lead to the appointment of the members of the Petroleum Sector Administration Board.

It is estimated that since the date tender offers for gas extraction are launched, actual production can start in a 6-year period. Under the production phase, Lebanon would earn revenue from oil firms under 3 forms in accordance with the Petroleum Law, namely royalty fees, shared oilfield profits and taxes on companies' earnings. Revenue from royalty fees and the State's share of the profits will be poured into a sovereign fund while taxes will be transferred to the State Treasury. Lebanon still has to ratify a law on an oil sovereign fund and to issue the executive decrees pertaining to oil and gas regulations.

Any forecasting scenario shows that gas extraction would indeed provide a long term softlanding to Lebanon's public finances and put an end to its fiscal conundrum. We hereby assume one of such scenarios where no significant structural reforms are undertaken prior to the production period, i.e in Phase 1 or the next six years. During that phase, debt servicing could be assumed to be maintained constant, while non-interest expenditures would grow by an average of 7% and resource mobilization is maintained at circa 24% of GDP. Real GDP growth could be assumed to revolve around a 4% average per annum in Phase 1, keeping debt to GDP within a narrow range.

According to this scenario, gas production will start in late 2018 or early 2019 (Phase 2) on the basis of production by countries with similar gas reserves as Lebanon's preliminary reserves estimate of 730 billion cubic meters. Gas production would serve to reduce the annual EDL subsidy (US$ 2.2 billion on average), with the extra production sold to neighboring countries (US$ 1.2 billion on average). The cost of debt servicing is assumed to decrease by 50 basis points per annum starting the extraction period. Accordingly, a surplus in the budget will start appearing in 2019 and Debt/GDP will be reduced gradually since then to reach below 50% by 2025.

While the materialization of gas extraction is apt to provide a softlanding for Lebanon and its economy, this does not mean that policy makers can sleep on their laurels awaiting for that "blessing" day to come. Current efforts should focus on avoiding a deterioration of fiscal ratios in a period where public finance imbalances are on the radar screens of any investor, analyst or observer around the World. For Lebanon to be able to benefit from such a long term blessing, its overall economic, financial and markets stability needs to be preserved by finding means to reinforce resource mobilization, reduce fiscal evasion, rationalize spending and adequately manage its overall public indebtedness to avoid an era of market drifts that jeopardize its accrued stability achievements of the past couple of decades.

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