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The Lebanese Economy Before and After

SUMMARY OF KEY MESSAGES

>> Lebanon boasts a solid, open and promising economy, supported by a highly educated and skilled labor force, placing it at the top tier Arab GDP per capita. The financial system, the oldest in the region and one of the most developed, has long been a source of pride for the country.

>> Several shocks tested the economy and the financial system, but unveiled solid foundations. Diversions from trend were quickly reversed, and upsurge in foreign direct and portfolio investment, construction activity, exports and tourism since late 2005, are a reflection of the strong confidence in the country's potential, especially among Arab investors and tourists.

>> Recent Israeli aggressions, despite their negative effects on the infrastructure, showed one more time the resilience of the financial sector in general, and the banking sector in particular, to shocks.

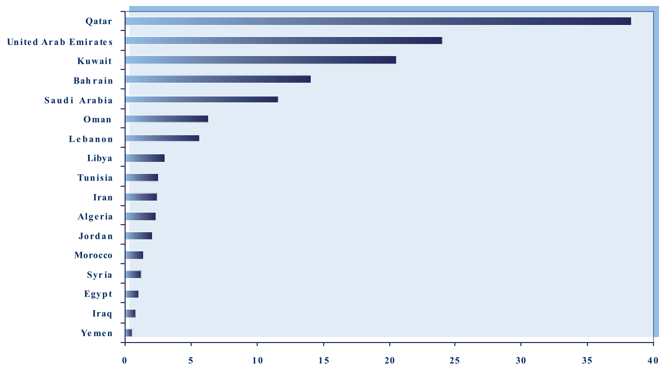
>> The country is expected to weather the effects of the war supported, by a high level of reserves at the Central Bank, covering over 17 months of imports, as well as strong support from the international community exceeding $2 billion in grants.

>> Banks remain well placed to play a major role in the economic comeback of the country. They are large, sophisticated, and profitable. Most importantly, especially in times of crisis, they are highly liquid: deposits are over 300% of GDP, loans to deposit ratio is around 32%, and offshore liquidity is around $13 billion, the equivalent of 60% of GDP or 30% of foreign currency deposits.

SOLID FOUNDATIONS

Lebanon has a small, open, services-based economy. Its population is estimated to be 3.5 million and GDP is around $22 billion, hence a GDP per capita that exceeds $6000, the highest among non-GCC Arab countries. This stems from a highly literate, multilingual workforce with education having long been one of the country's strengths. According to the UNDP, overall adult literacy rate stood at some 87% in 2003. The ratio stood at 96% in the 15-24 age group, suggesting that the overall literacy figure will improve further in the coming years.

Selected Countries GDP Per Capital

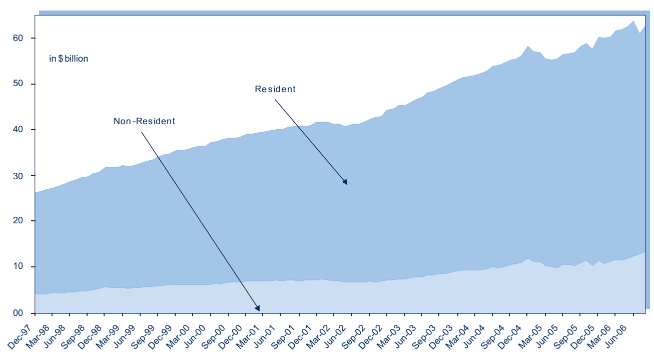


The country's most important area of economic activity is services, which accounts for around 70% of GDP. Trade remains prominant, which is only natural for a country that is rich in human capital and many multilingual entrepreneurs. In fact, the services focus explains why most economic activity is generated in the coastal cities, and why domestic consumption is biased towards imported items. Tourism contributes significantly to economic activity, and a rapidly growing, high-end industry is catering mostly for wealthy Arabs from Gulf countries.

The industrial sector, accounting for around 18% of GDP, has traditionally been small, owing largely to the relatively tight domestic market. However, the sector has been showing great potential recently, especially for the exports market, which grew at a rate of 15% in 2005. Among the sector's most significant exports are cement, processed food and beverages, and jewellery-with the latter showing strong growth over the past two year.

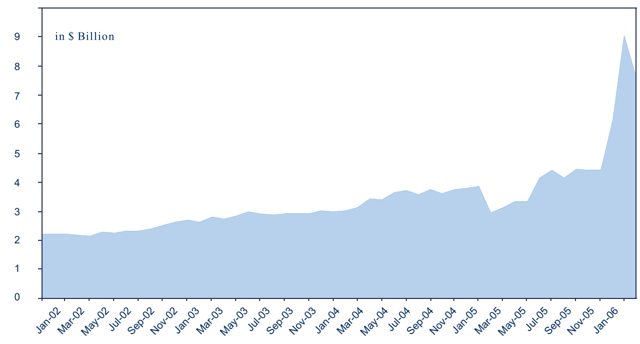
The Lebanese financial system, the oldest in the region, boasts a strong banking industry, a highly liquid and efficient money market, and a rapidly growing equity market. Financial market stability is further fostered by a closely managed exchange rate, which has been pretty much pegged to the dollar at 1507.5 since 1998.

Commercial Banks Deposits



Beirut remains a significant regional banking center. A strong deposit base as well as substantial capital inflows from a vast expatriate community and wealthy Arabs has generated a highly liquid financial system with total deposits of around $65 billion, almost 300% of GDP. Dollarization of deposits, at around 72%, reflects the openness of the system, and has provided a buffer in times of financial turbulence. The money market, supported by sound debt management by the ministry of finance, strong open market operations by the central bank, and a liquid and efficient interbank market, is also an essential pillar of the Lebanese financial system. In addition, the stock market is emerging as the third pillar of the financial system. With a capitalization of over $7 billion and around 25 listings, the Beirut Stock Exchange has witnessed strong growth in the last years and is expected to grow further as many companies are lining up to list and raise capital on the equity market.

Beirut Stock Exchange: Market Capitalization



RISING UP TO THE CHALLENGES: 2005 AND 2006

>> OVERCOMING THE SHOCKS

The economy has shown an incredible resilience to shocks in the context of a volatile and violent environment in 2005 and 2006. Lebanon was able to weather the confidence hit created by Prime Minister Hariri's assassination in February 2005 and the political instability that followed. The country, tested again by the recent Israeli war, has shown solid foundations despite all difficulties.

The economy was climbing on an upward trend in 2004, supported by a surge in tourism, construction activity and strong exports, generating to a GDP growth of 6% in 2004. A political earthquake, however, caused by the assassination of PM Hariri, prompted a serious diversion and reduced growth to 1% in 2005. But lower growth was the only economic calamity. In fact, the horrific event, ended up reflecting, ironically, how robust the financial system is. Pressures on the financial market triggered by the assassination of PM Hariri, and reflected by withdrawal of deposits and increase in dollarization eventually dissipated, largely due to innovative financial engineering by the Central Bank. Deposit inflows resumed at a high pace, accompanied by gradual de-dollarization. The $750 million Eurobond issue of October 2005 was heavily oversubscribed, notably by international investors, and by mid-March 2006, Eurobond spreads had declined to a record low 180 bp. The stock mark picked up significantly in the summer of 2005, and despite a sizeable correction in February 2006, it was still up 150% over its end-2004 level.

Lebanon EMBI Global Spreads

>> A PROMISING POTENTIAL

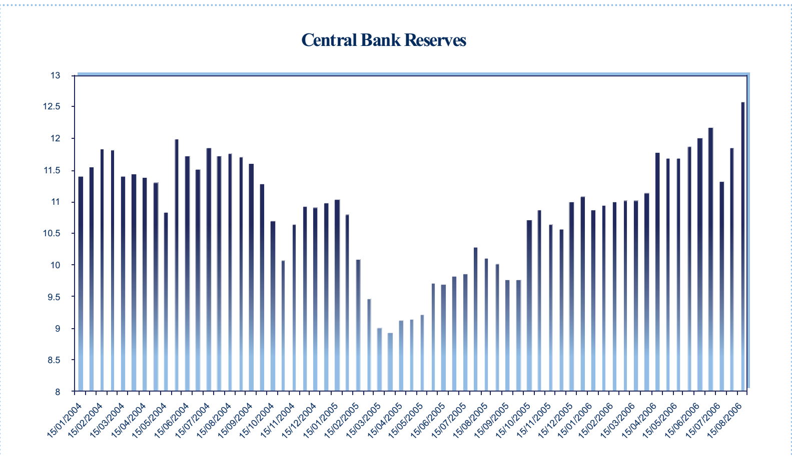
Investment picked up heavily in the summer of 2005, after a successful parliamentary election released some of the political tension, prompting solid foreign direct investment, especially from private Arab capital which contributed 1.8 billion, in 2005, giving Lebanon the third place after Saudi Arabia and Sudan in total Arab investments.

The first six months of the 2006 were a powerful indication of a substantial pick up in economic activity, and revealed the promising potential of the Lebanese economy: net foreign direct investment reached $1.68 billion, and foreign portfolio investment reached $1.72 billion, contributing to a record high surplus of $2.6 billion in the balance of payments. Meanwhile, bank's deposits increased by around $4 billion, of which $1.35 billion were by non-residents, and their loans increased by a record growth of 7.4% to reach around $18.6 billion. Passenger activity at the airport was up to 1.6 million passengers in the first half of 2006, pointing to a promising tourist season of an all-time high 1.7 million visitors. These indicators, among others, were signaling an expected growth rate of over 6% in 2006. This rate, sadly, would remain an unrealized scenario as a sudden war would one more time test the foundations of the Lebanese economy.

>> ANOTHER TEST

The economic consequences of the July 2006 war were severe, by the sheer fact of the systematic destruction of the infrastructure, factories, and residential neighborhoods. Estimates of the physical damage range between $2 billion and $3 billion, which will result in a zero or negative growth rate for 2006.

The financial system, on the other hand, showed one more time an incredible resilience and an ability to weather the storm. In fact both withdrawal of deposits and increase in dollarization were at levels lower than those that followed PM Hariri's assassination. The deposit base shrank by 3% and dollarization increased from 72% to 75% before trending down again. This caused a total intervention by the central bank of only $2.4 billion. The trend was quickly reversed and reserves (without gold) actually increased from $12.1 billion just before the crisis to reach an all time high of around $12.6 billion by the end of August, boosted by generous deposit from Saudi Arabia and Kuwait. At this level, reserves cover 17 months of imports. In addition, the large stock of gold, estimated at around $5.7 billion has long been a source of comfort to the country.



In financial markets, Eurobonds spreads reacted only moderately to the war, while the stock market after losing around 15% in the days that followed the war, has almost recouped its value. In fact, Solidere, the largest listed company, has its share prices higher than their December 2005 levels despite all the war turmoil.

>> GOING FORWARD

Clearing the physical and infrastructure damage left by the war, while tedious, should not pause a challenge. A strong commitment from the international community for abundant support was stated clearly in United Nation Security Council Resolution 1701 which ended the hostilities. Generous grant support from Arab and other countries has already exceeded $2 billion. Several Arab and Lebanese businessmen did not wait the official routes and have already started plans to repair on their own expenses bridges that were destroyed by the hostilities, while top companies from the Gulf, such as Taamir Holdings, and Al-Khurafi Group, and the CCC, have taken on their behalf major reconstruction projects.

The outlook for the economy will depend on the political endgame. A muddle through scenario which will makes it difficult for a final settlement to emerge, will surely affect investment, tourism, and hence growth, but will not pause major financial risks. As a matter of fact, the latest report on country risk by the Economist Intelligence Unit (EIU) in August 2006, classified sovereign risk as stable, banking sector risk as stable, and currency risk as negligible, underpinned by record level of reserves at the central bank.

Stability is further enhanced by the lack of major financing needs in the short-term. In fact, debt management by an experienced and ministry of finance has always been proactive. For instance, the government has almost completed its 2006 financing needs with swap operations undertaken in April of this year where 71% of Eurobonds falling due in 2006 were exchanged for longer-maturity bonds.

A clear political settlement of standing issues, on the other hand, will raise confidence and boost investment both domestic and foreign. Under this scenario, the growth rate will exceed 8% in 2007 due to the reconstruction drive, and would probably settle on a trend of 6-8% in the coming years supported by strong foreign direct and portfolio investment, a pick up in construction and resurgence of tourism. Deposits at the domestic banks will grow by over 10% per year, providing the necessary support for domestic investment and government borrowing.

A CLOSER LOOK AT THE BANKING SECTOR

The Lebanese banking sector is large and well developed. It consists of around 50 banking groups, with total assets of $75 billion as of end-June 2006 or 3.5 times GDP, one of the highest ratios in the world. The banking sector is well capitalized, with a capital adequacy ratio of around 23%. The sector is also quite profitable. Profits in 2005 were $578 million and as of end-June 2006, year-to-date profits were $379 million.

The sector is highly dollarized which provides a buffer in times of crisis. Deposits total $65 billion, of which $46 billion or 72% are in foreign currency, while loans are $22 billion of which $19 billion or 86% are in foreign currency. Dollarization reflects in essence the highly open Lebanese economy, and together with the stable exchange rate has constituted a buffer against financial turbulence in times of crisis and high volatility.

The banks are extremely liquid with loans to deposits ratio of 32%. The Lebanese financial system is estimated to hold around $23 billion in primary liquidity in foreign currency against a foreign currency deposits base of $46 billion in the domestic banking system, resulting in a primary liquidity ration of 50%. In addition, the balance of external assets held offshore by Lebanese banks is estimated at $13 billion, i.e. 60% of GDP and 30% of foreign currency deposits.

The banking sector in Lebanon is quite concentrated with the top 10 banks, which are highly regarded within the region, holding 76% of the sector's assets. These banks (in assets descending order) are BLOM Bank, Bank Audi, Byblos Bank, BankMed, Fransabank, Bank Libano-Francais, Bank of Beirut, Credit Libanais, SGBL, and the Lebanese Canadian Bank.

Banks in Lebanon are quite diversified in terms of loan portfolio, with the commerce sector absorbing 21% of the loans, consumer (retail) loans absorbing 18%, construction sector absorbing 15% of the loans, and the industrial sector absorbing 14% of the loans.

According to the EIU, major positive factors underpin the strength of the sector. To quote the August 2006 country risk report: "the banking sector is large, sophisticated, highly liquid and profitable. Overall assets have been growing strongly for more than a decade, financed in part by the sector's success in attracting substantial non-resident deposits. In addition, Banque du Liban (the central bank) is a competent regulator, and has in the past been effective in uncovering and containing bank crises."

Weaknesses however are also noted. In particular, the EIU notes that the banking sector's exposure to government debt constitutes a vulnerability. Additional concerns about the effect of the war on key sectors such as tourism and real estate are also noted. But while these concerns are legitimate to the foreign observer, familiarity with the Lebanese market and banks should dissipate them. The aggressive stance of the top Lebanese banks to expand regionally and hence to be better prepared for the implementation of Basel II will significantly reduce the concentration risk. As for damaged sectors, banks exposure in hit areas is minimal, though indirect effects may of course be bigger.

THE BOTTOM LINE

Lebanon has withstood many political shocks in its history, particularly in the last two years. The Lebanese economy's foundations were tested, but never collapsed, and growth was diverted from its trend, but picked up at every opportunity. The Lebanese financial market in general and the banking sector in particular have proven extremely resilient to shocks, partly through the years-long gained experience of steering through turbulence. A recent report by JP Morgan confirms that Lebanon's financial system has mitigated the risks. Furthermore, Bear Stearns has just raised recommendation on Lebanon's fixed income sovereigns to "marketperform", while Barclays Capital raised it to "buy". These are strong indications by top global investment banking and finance firms of their continued confidence in the country's financial prospects.

LEBANON ECONOMIC INDICATORS

	2002	2003	2004	2005	2006(e)
GDP growth	2.9	5	6	1.1	0
Inflation	1.8	1.3	3	0.3	3
GDP in $ Billion	18.4	19.8	21.7	22	22
Average banks' deposit rate on LP, in %	11	8.7	7.4	8.1	8
Average banks' lending rate on LP, in %	16.6	13.4	10.8	10.6	10.2
Yield on 24 month T-bills, in %	14.1	7.8	8.3	8.5	8.5
Exports in $ Million	1012	1445	1584	1826	1760
Imports in $ Million	5962	6633	8680	8668	8690
Current account in $ Million	-2842	-3026	-3969	-2792	-2995
Foreign direct investment in $ Million	1385	1558	1478	2100	2000

Source: IMF, World Bank, EIU, and BankMed.

TOP 10 LEBANESE BANKS- MAY 2006

	Assets	Capital	Deposits	Loans	Gov. Debt Holding
	in $ Million				
BLOM Bank	12586	1065	10694	2308	2642
Bank Audi	12477	1422	10391	3020	2202
Byblos Bank	8203	622	6191	1990	2541
BankMed	6682	458*	5681	1805	2522
Fransabank	5095	317	4192	1069	1768
Banque Libano Francaise	4758	383	3884	1752	840
Bank of Beirut	4380	344	2980	1133	1545
Credit Libanais	3379	305	2925	737	1237
SGBL	2824	126	2200	1221	479
Lebanese Canadian	2741	122	2376	504	676

* Total shareholder's equity is $713 million as of end June 2006.
Source: BankMed.

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