

BankMed Economic and
Market Analysis

INTO THE CROSSROAD
SEMI-ANNUAL UPDATE
JULY 2007

SEMI-ANNUAL UPDATE

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INTO THE CROSSROAD

BankMed Research Division released in January 2007 the annual economic and market analysis report covering the main challenges that were expected to face the Lebanese economy in the year ahead. The report, titled "Lebanon in 2007: at a Crossroad", underlined the fact that we did expect 2007 to be difficult. Our argument that the country has been going through a crucial political and economic transition period, which leaves open the many scenarios that could come at play, was validated by the sequence of events. On the negative side, the political stalemate was further engrained, and the security situation deteriorated in the North on the back of a terrorist assault on the Lebanese army, as well as through recurrent outbreaks of car bombs. On the other hand, a donors' conference in Paris assembled an impressive contribution and underlined the faith of the international community in Lebanon, and an ambitious reform agenda was launched by the government.



In the midst of all this, the broad political and economic consensus paving the way to much needed reforms, and hence to strong and sustained economic growth, has yet to emerge. This was further compounded by the deterioration in the security situation in the North and through various terror bombings in the country. In fact, just as we were bracing off for a much awaited V-shape recovery this summer, security concerns surfaced again, posing a big question mark on what else lays ahead. The Lebanese, as a result, seem as uncertain as ever about the prospects of their businesses and economic well being, and making decisions of a business or economic nature is hence further complicated by the overwhelming uncertainty. In this report, we do our bit of analysis, and provide our clients with an update on the economic and business environment prevailing as of mid-year. We hope that you find it useful and informative.

Mazen M. Soueid

Chief Economist
Head of Research

THE MISSING LINK

The end of the five-week Israeli war, which has caused Lebanon a human loss that could never be compensated, in addition to around \$5 billion in direct and indirect economic and business damage, should have provided the various Lebanese factions with the incentive to set differences aside and join hands in the recovery process. The international community gathering together in Stockholm (in August 2006) then in Paris (in January 2007) was generous in both its economic and political support for the reconstruction process, as well as for a locally-designed reform agenda that aims at reducing the debt dynamics to a sustainable path and generating private sector driven economic growth.

Almost 10 months since the cessation of Israeli hostilities and the Stockholm Conference, and 5 months since the conclusion of the Paris III (Rafic Hariri International) Conference, the Lebanese economy has yet to recover from the zero percent growth rate realized in 2006. First four months economic activity data reflects minimal, if any, growth. Few bright spots such as construction and exports have been overshadowed by a dimming of the overall business environment. Ongoing efforts to rein in the fiscal deficit and stabilize the debt level are constantly compromised by the lack of reforms in the cash-starved public enterprises and ventures such as the Electricite du Liban (EDL), and the social pension fund (NSSF). Meanwhile, the deteriorating security situation has caused ever increasing demand on the army and the internal security forces and extra funding to these institutions is more necessary than ever.

The missing link between a V-shape recovery that was forecast for 2007 by international organizations such as the International Monetary Fund (IMF) or even by market intelligence sources such as the Economist Intelligence Unit (EIU), and the very modest growth and investment that has materialized so far in 2007, is a deepening of the political stalemate that has paralyzed the institutions and crippled the economy. To make things worse, and just as the economic and business communities were lobbying for a 100 days truce ahead of the summer in an attempt to neutralize the effects of the stalemate on the economy, a major security development in the North threw a big question mark on the outlook of the summer season, usually an essential contributor to growth in the tourist-dependant Lebanese economy.

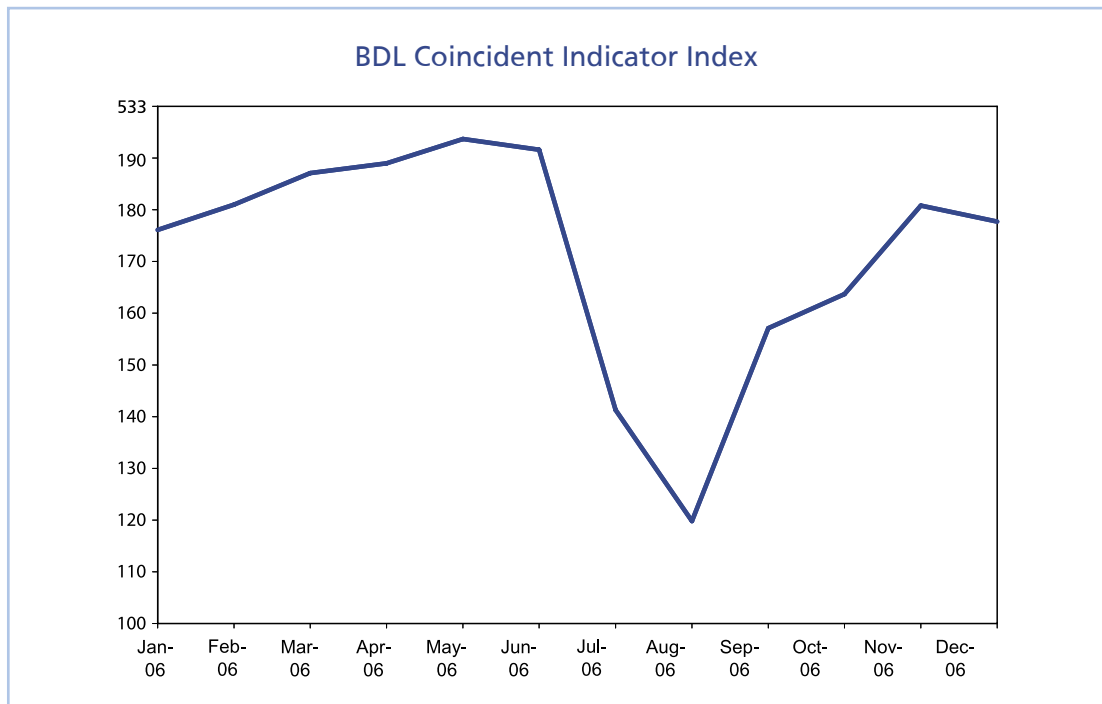
The next sections analyze in detail the development in economic activity, public finances, and financial markets since the end of July war and through the Spring of 2007, and update the economic and business forecast for 2007 in light of the recent developments. They argue that the inertia that dominated in the last part of 2006 propagated further into the first half of 2007 and resulted in minimal growth. While inflation abated and the financial markets remained immune, the fiscal situation worsened. Banks saw a mild increase in deposits, but assets seemed to move from public to private sector claims. While Paris III donors' commitments would reduce the level of this year's financing need and hence keep the debt level relatively stable, urgent reforms are needed to face large amortization obligations over the medium term.

ECONOMIC ACTIVITY

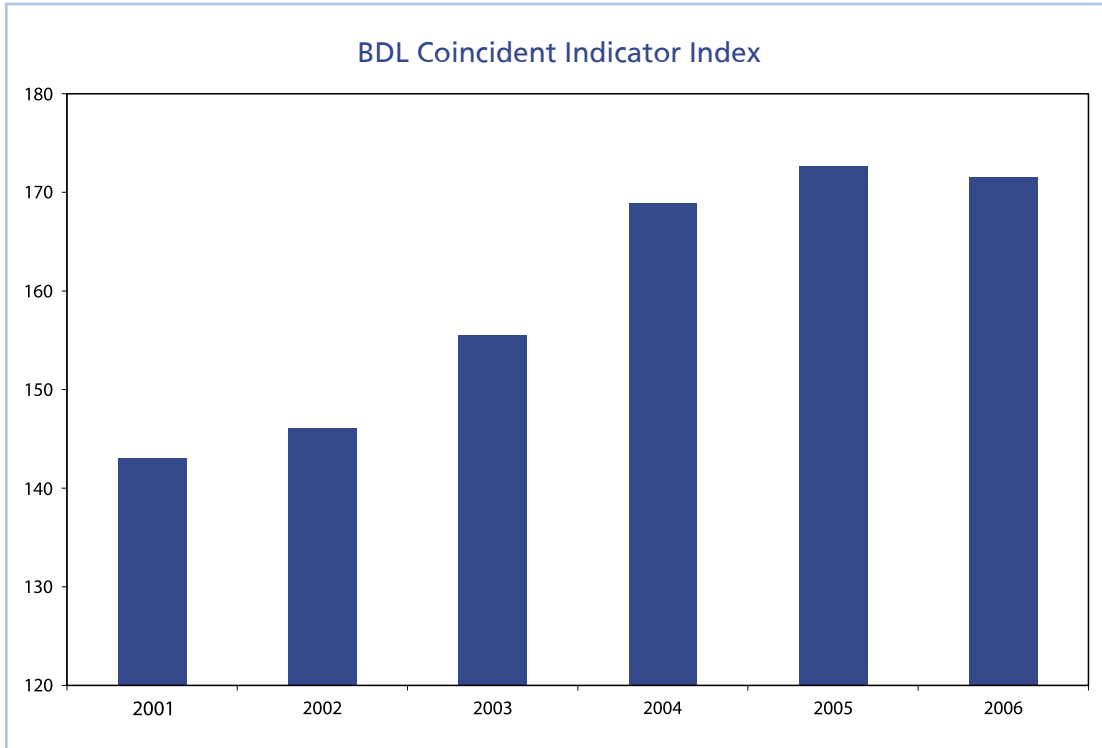
The inertia in economic activity that prevailed in the aftermath of the war, continued well into 2007. A political stalemate caused by the opposition demanding veto power within the government, and the refusal of the pro-government parties to yield before agreeing with the opposition on the main political and economic mandates of the government-to-be, has been engrained further since hostilities ended in August. An open ended street sit-down in the heart of Beirut Central District to unseat the government has crippled economic activity in the otherwise vibrant "downtown". But the effects were also felt across the country, as a collapse in confidence led to stalling investment and consumption on the national level.

Several indicators could be used to infer the level of economic activity. The central bank (BDL) Coincident Indicator and the total value of cleared checks are important measures for the overall economy. But certain sectors in Lebanon are of particular importance and hence should be looked at individually. The construction sector, the tourism sector and the external sector, reflected by both trade and capital flows, are all of particular importance to the Lebanese economy. To gauge construction, we look at cement deliveries, construction permits and real estate tax revenues. For tourism, the arrivals at Rafic Hariri International Airport is usually a good indicator. As for trade, data on exports, imports and balance of payments gives a full picture on the net flow of goods and capital in and out the country.

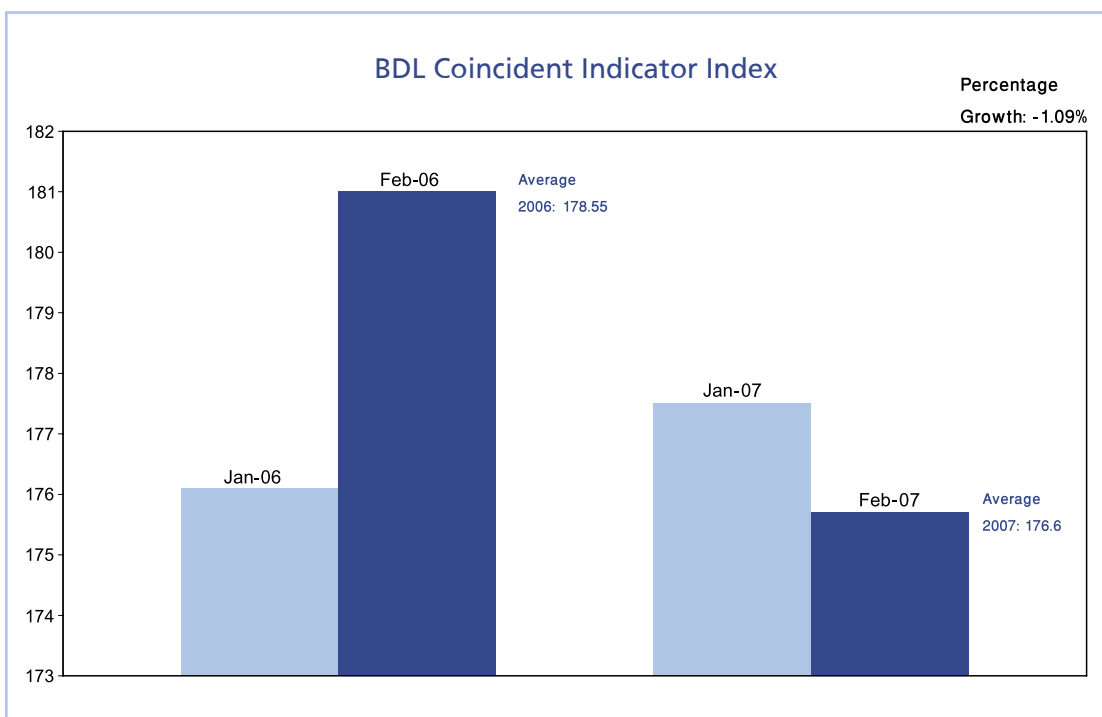
The overall level of economic activity could be gauged through the BDL coincident indicator. This index, compiled and published by the central bank using data on economic activity, peaked pre-July war and was severely hit during the hostilities. It ultimately recovered but never to its pre-war levels.



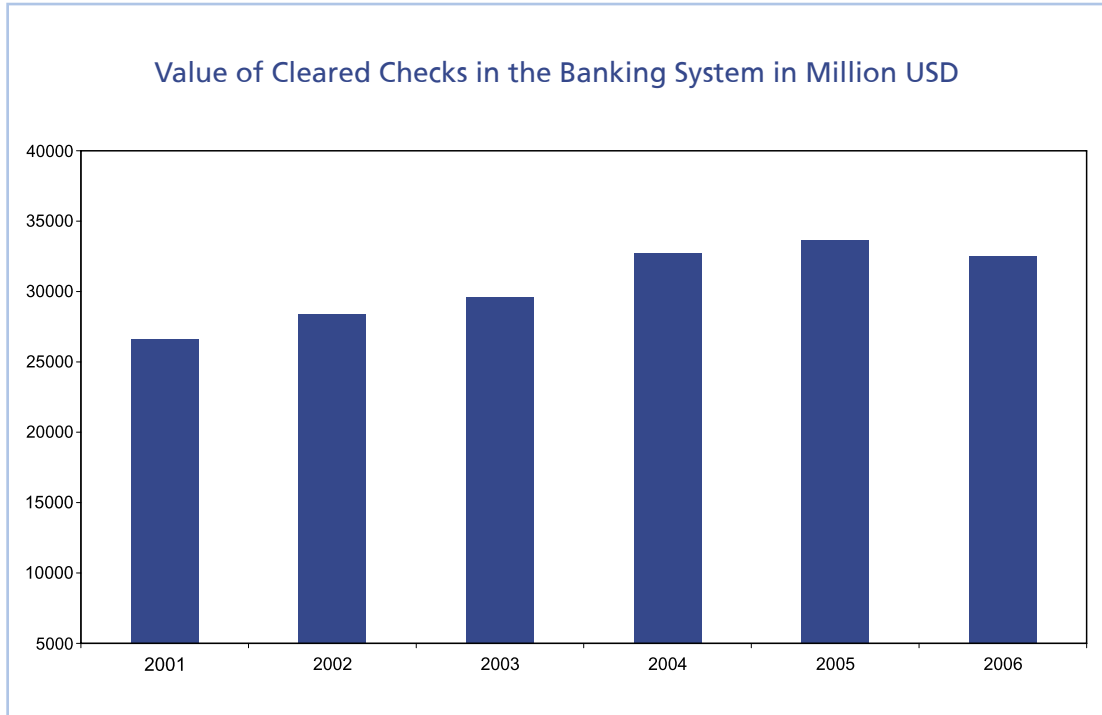
As a result, the indicator closed slightly down on the year, averaging 171.5 in 2006 compared to an average of 172.6 in 2005.



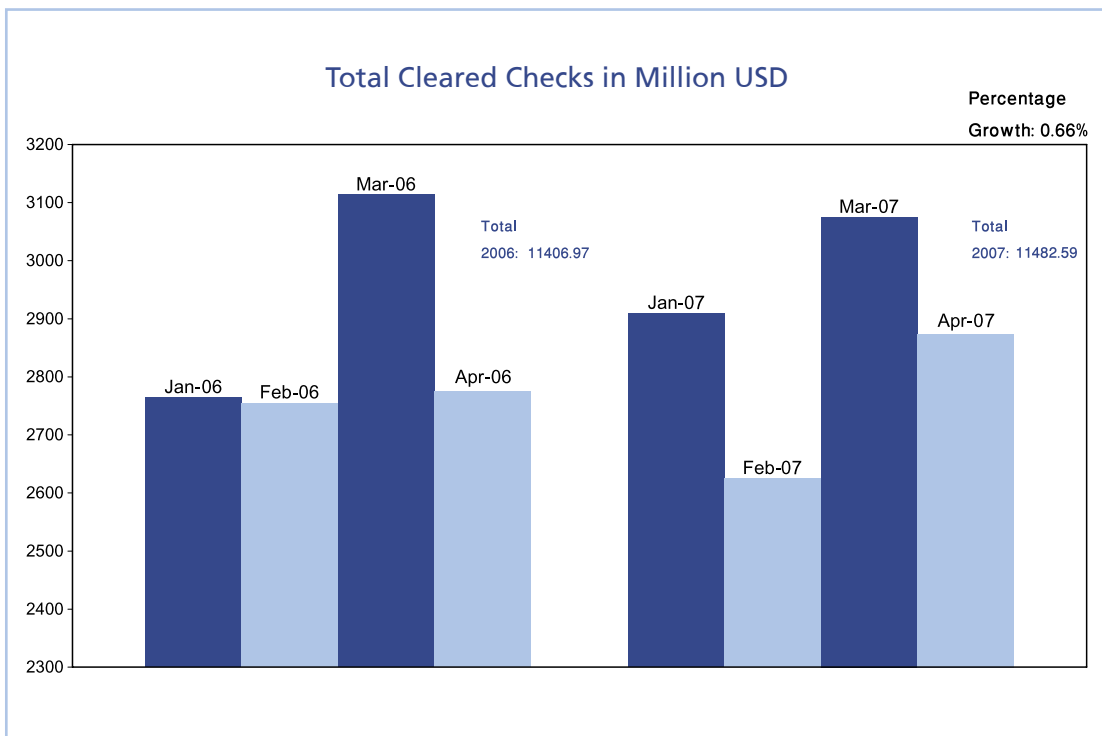
The index closed at 177.7 in December 2006, and remained around there in January and February of 2007. Comparing month on month with 2006, the coincident indicator was slightly better in January 07 but worse in February 07. The indicator averaged 176.6 in the first two months of 2007 compared with 178.5 in the first two months of 2006, i.e. a decline of around 1%. While the data is still unavailable, it is unlikely that the indicator picked up in the Spring or early summer given the most recent developments in the North.



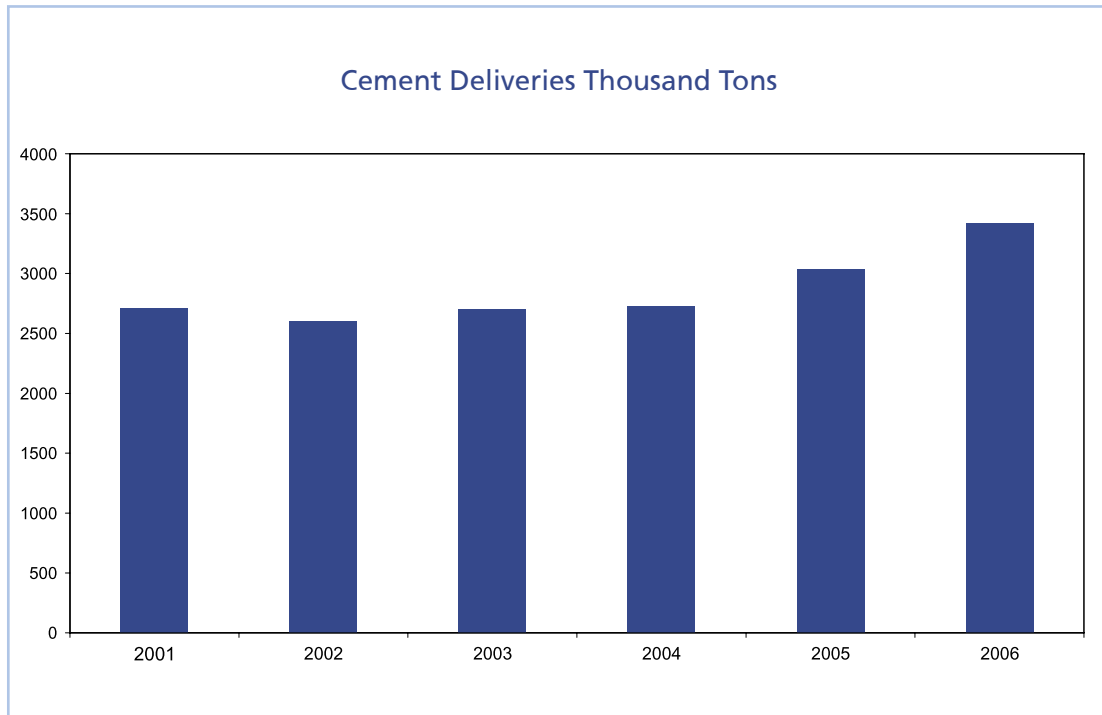
The value of cleared checks, another important indicator of economic activity, also peaked by mid-year 2006, but plunged during the war. A full recovery in the value of cleared checks to pre-war levels has yet to be achieved. In fact, the total value of cleared checks went down to \$32.4 billion in 2006 from \$33.6 billion in 2005.



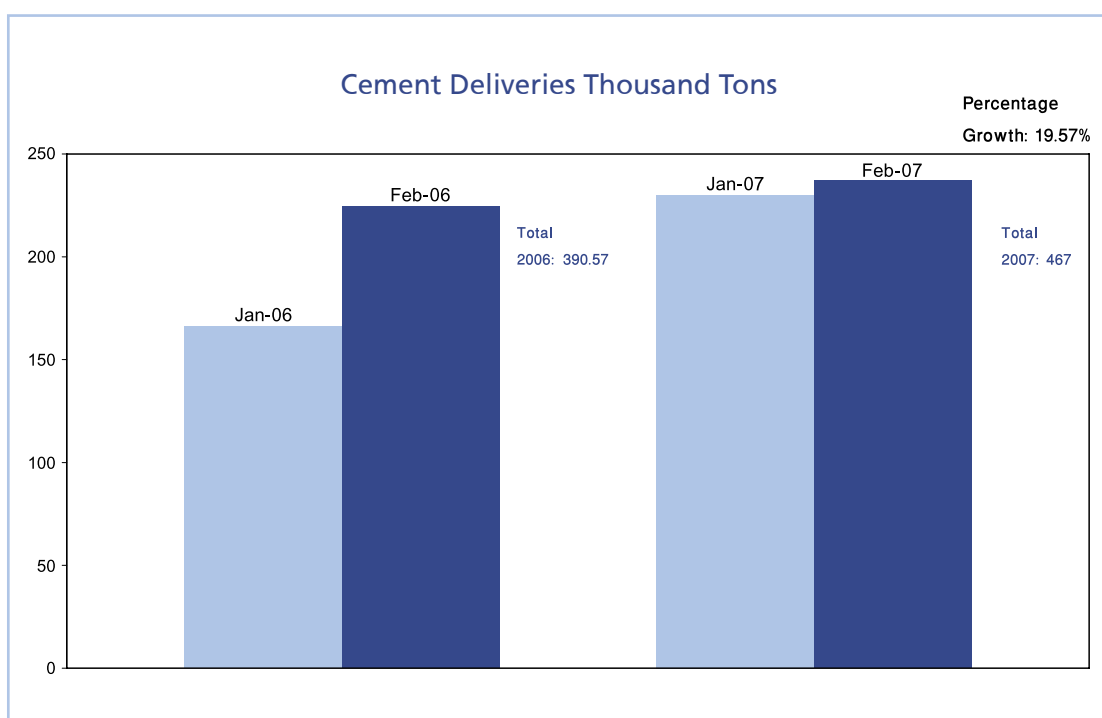
Cleared checks were almost flat in the first four months of 2007 compared with the first four months of 2006. They totaled \$11482 million through April 2007, up 0.7% from \$11406 million through April 2006.



Examining the construction sector suggests that it was hit relatively less than the overall economy. One indicator is cement deliveries, which increased by over 12% to 3423 tons in 2006, from 3039 tons in 2005.

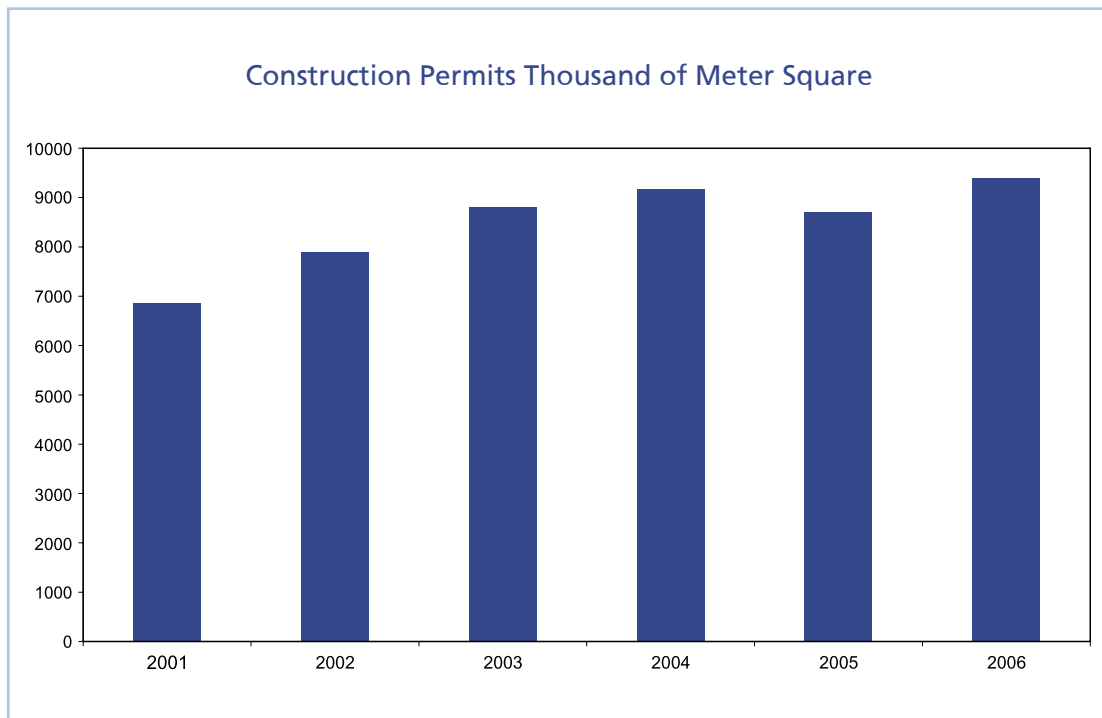


Cement deliveries continued to edge up in the first months of 2007 due to reconstruction after the July war and some re-exports. Total cement deliveries increased by over 19% in the first two months of the year to 467 thousand tons, compared to 391 thousand tons in the first two months of last year.



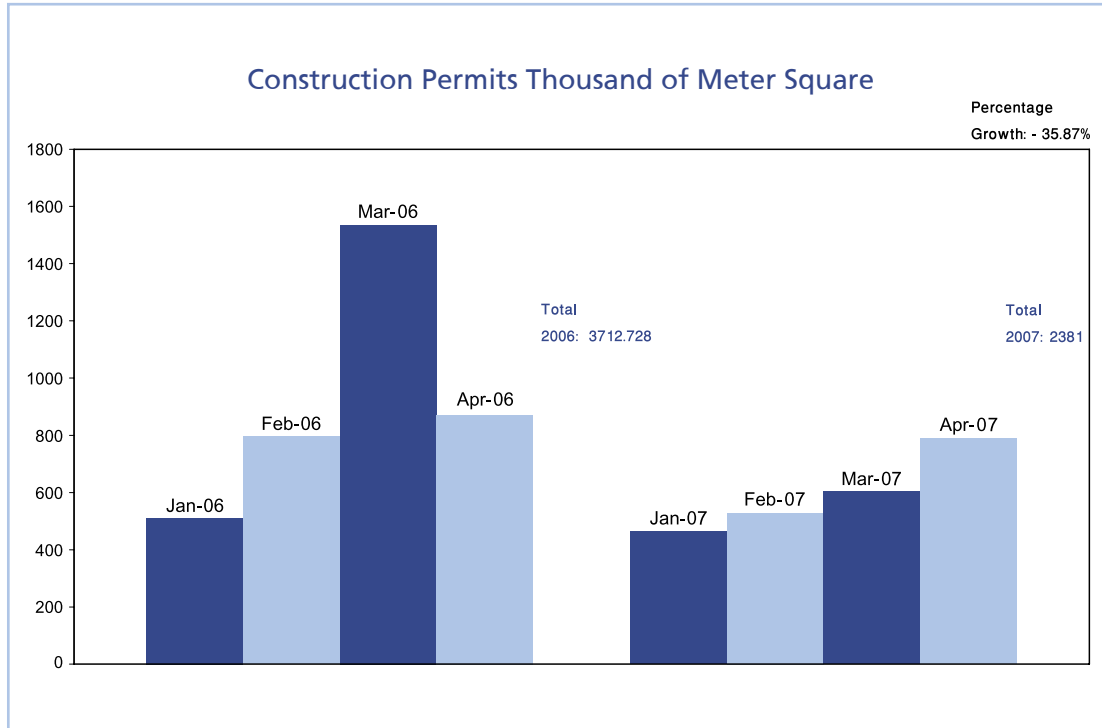
Cement prices have constituted an important component of the increase in construction cost in 2007. In fact, prices had originally dropped in Lebanon after the summer of 2006 when the three major cement producers (Holcim, Cimenterie National, and Sibleine) all agreed to the government request in September to drop, for one year, the wholesale price to \$65 per ton in order to spur reconstruction. However, significantly higher prices in Syria, which charges import duties of about \$40 per ton and which is witnessing a construction boom, have encouraged smuggling, which have raised prices to a range of \$130 to \$180 per ton, i.e. similar to prices in Syria. Recent efforts by the three main producers to deliver cement directly to builders are expected, however, to bring down the price back to a range of \$80-\$90.

Another measure of activity in the construction sector is the construction permits, which is a good gauge of confidence in the sector and expected future growth. In 2006, permits increased by around 8% to 9400 thousands of meters square from 8710 thousands of meters square in 2005.



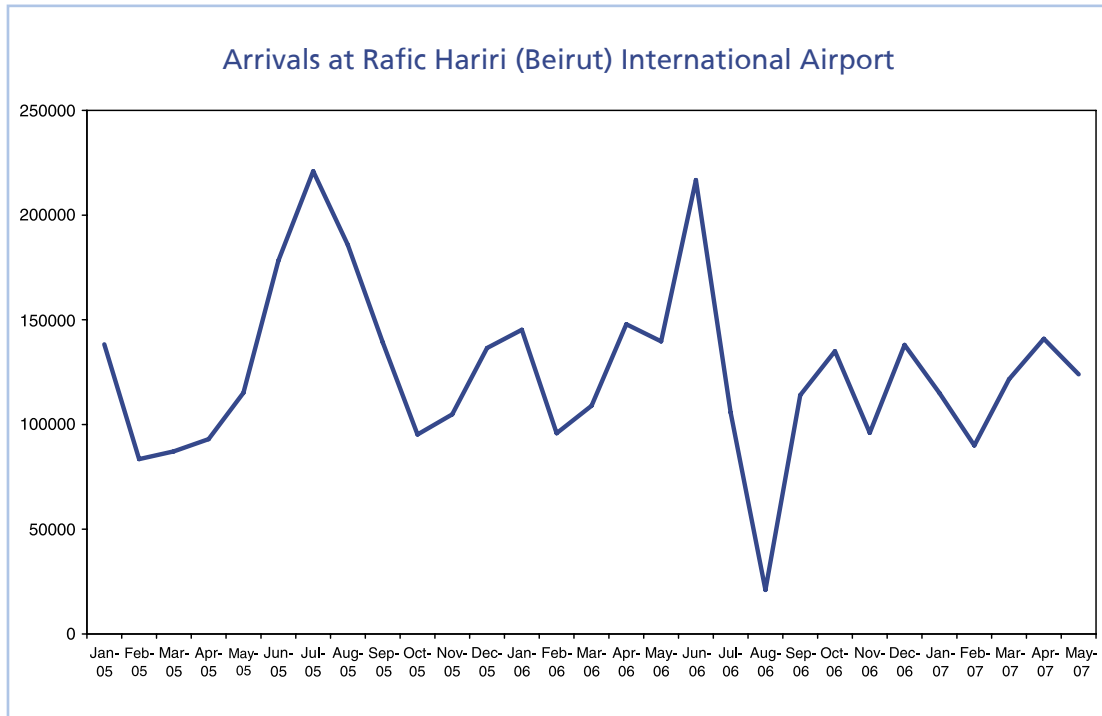
But probably reflecting the weakening of confidence which was caused by the sit-down of the opposition in Beirut Central District (downtown), construction permits saw a decline in the first four months of 2007 in comparison with the first four months of 2006. Total construction permits through April 2007 were 2381 thousands of meters square, a decline of around 36% from first four months of 2006 when construction permits totaled 3712 thousands of meters square.

The third indicator of activity in the construction sector is the taxes collected on real estate transactions. Taxes on property increased to \$384 million in 2006 from \$274 million in 2005. But activity seems to have cooled in the first quarter of 2007, causing property tax revenue to slip from \$60.8 million in the first quarter of 2006 to \$46.9 million in the first quarter of 2007. Additional data from the directorate of real estate at the Ministry of Finance suggests that most sales are taking place in the middle segment of the market, i.e. flats running from \$70,000-\$200,000, which are usually bought up by locals and some expatriates rather than by foreigners.

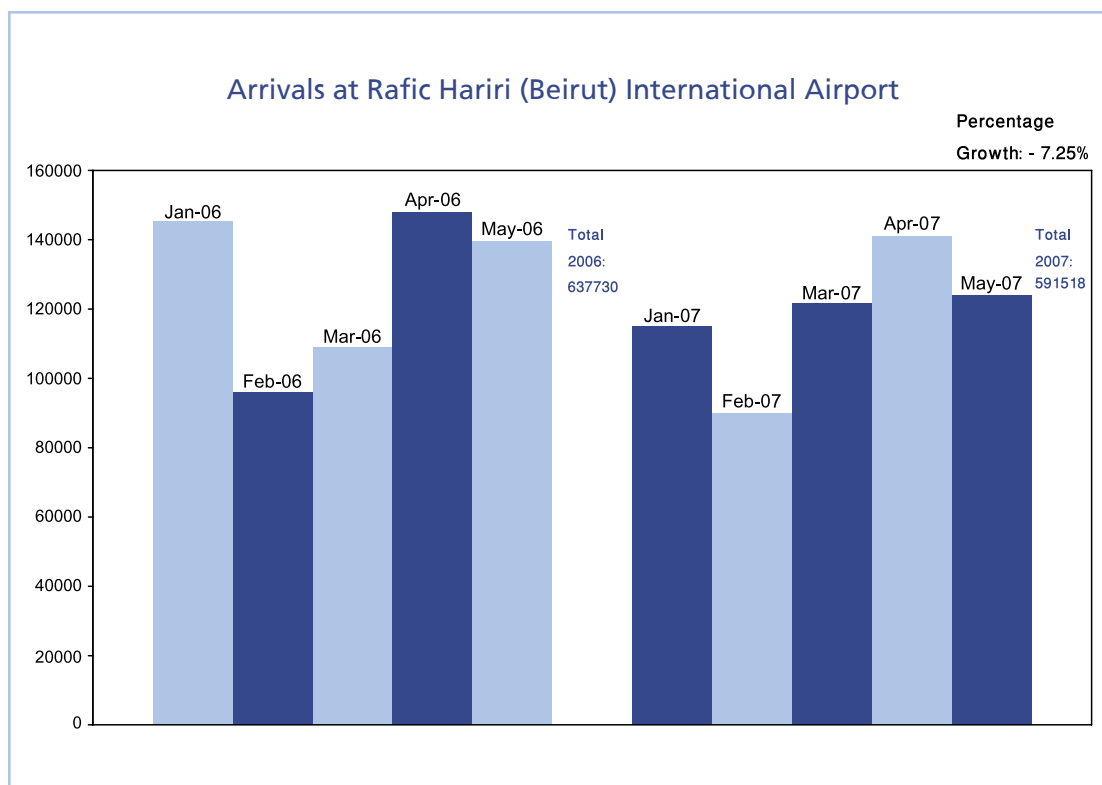


The tourism sector, which constitutes around 10% of Lebanon's GDP and employs around 150,000 individuals, was evidently the one that was hit the most in 2006, and continues to suffer in 2007. Arrivals at Rafic Hariri (Beirut) International Airport after peaking by mid-2006, collapsed due to the war and airport closure and have yet to recover to their pre-war levels. As a result, arrivals were down by around 8% to 1.46 million in 2006 from 1.58 million in 2005.



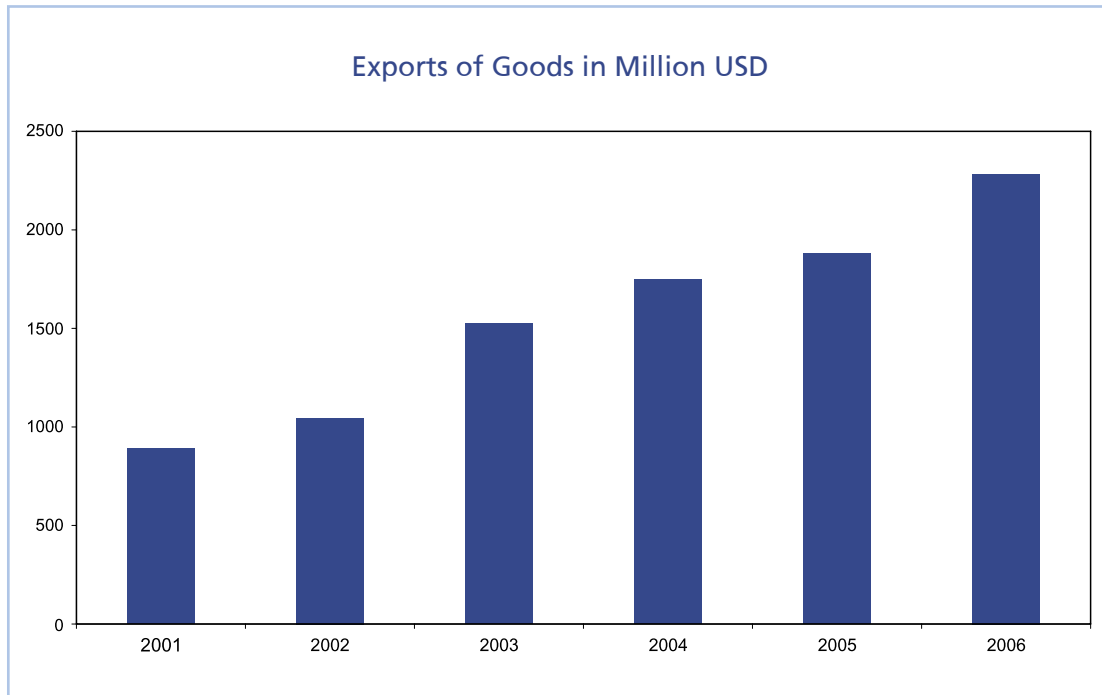


Tourism was evidently negatively affected by the political developments in 2007, and as a result, arrivals at Rafic Hariri International Airport were down in the first five months of the year. Total arrivals in January, February and March, April and May of 2007 totaled around 591 thousands, down by 7.2% from 637 thousands in the first quarter of 2006. While the data is still unavailable for the month of June, it is almost certain that the negative developments on the security front has caused a drop in expected summer-related arrivals.

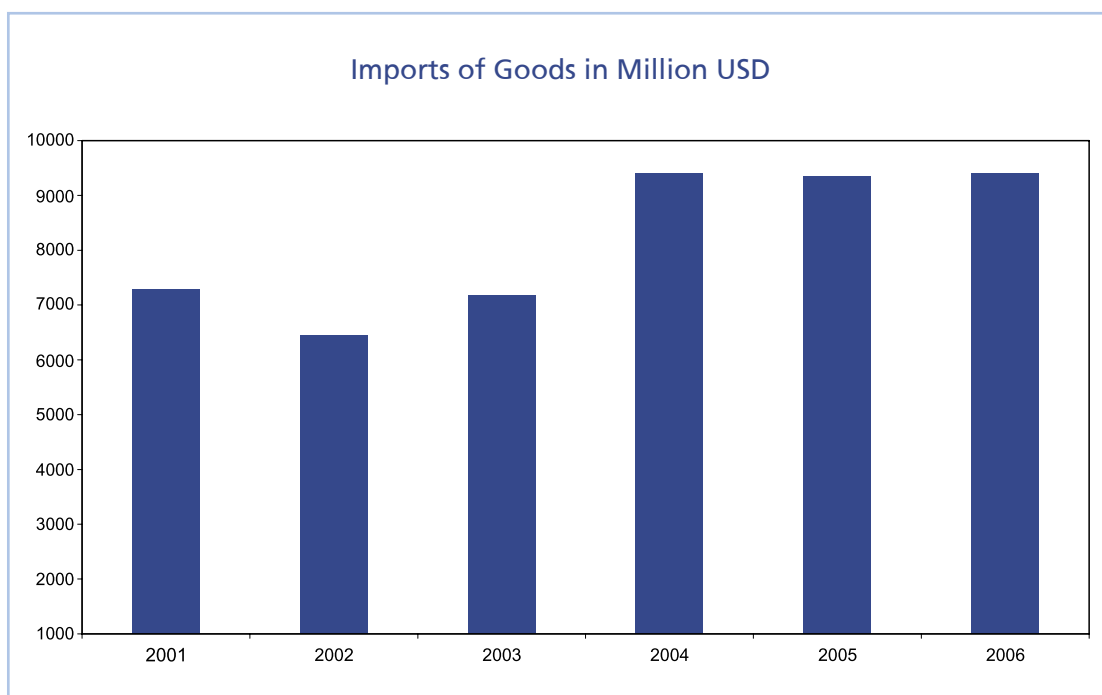


Lebanon has a fully open economy to flows of both goods and capital. As a result, indicators of foreign trade and the balance of payments provide a good indicator of domestic economic activity.

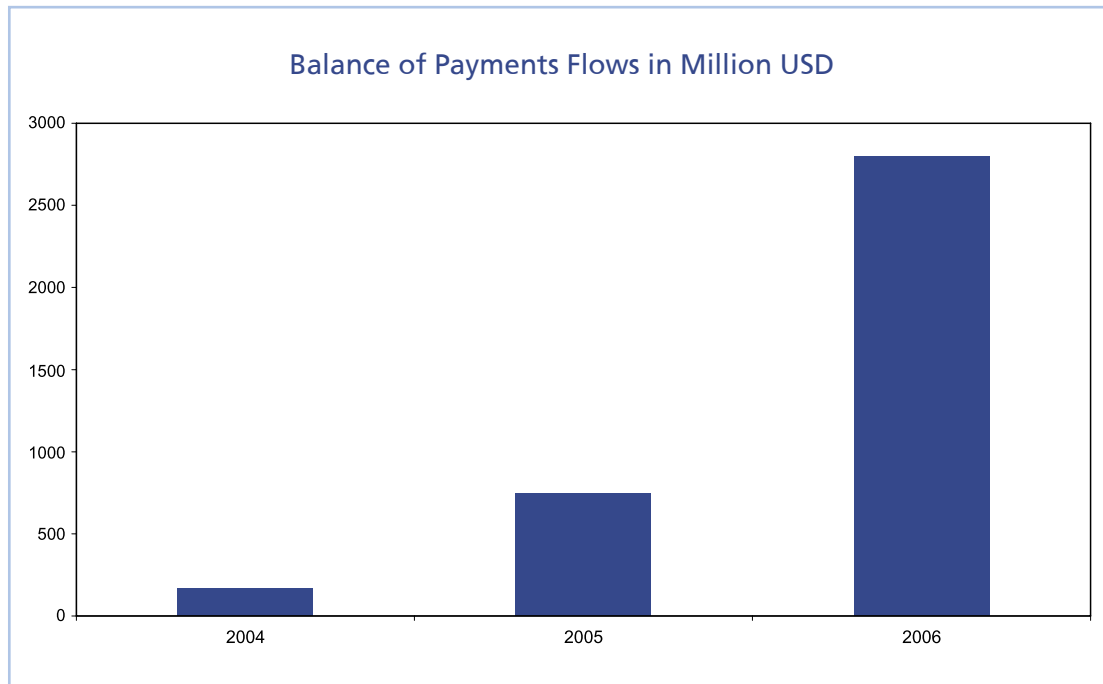
Regarding trade flows, exports have performed relatively well in 2006 and continued to do so in 2007, supported by the rise in the euro vis a vis the dollar. Lebanon, as a result, gained a competitive edge vis a vis Europe, its largest trading partner. Exports increased by over 21% to \$2283 billion in 2006 from \$1880 billion in 2005 with the jewelry sector, constituting almost a quarter of the total, showing an impressive growth.



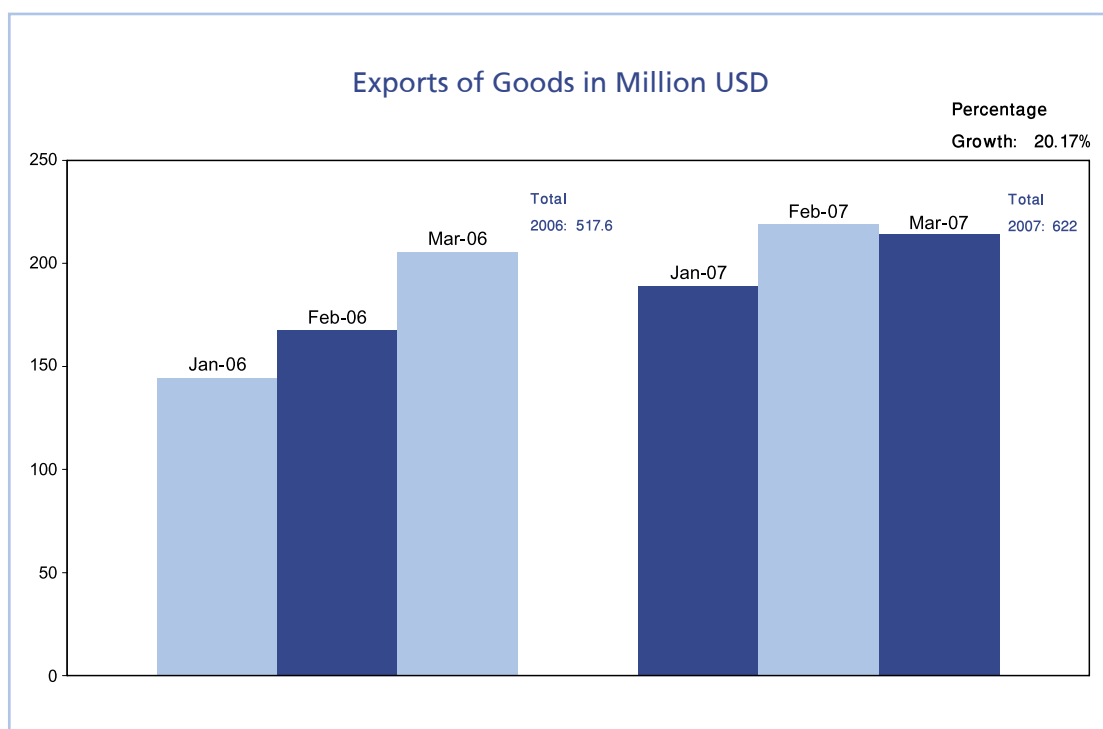
Imports, on the other side, were almost flat reflecting weak economic activity in 2006. They increased slightly to \$9400 billion in 2006 from \$9340 in 2005.



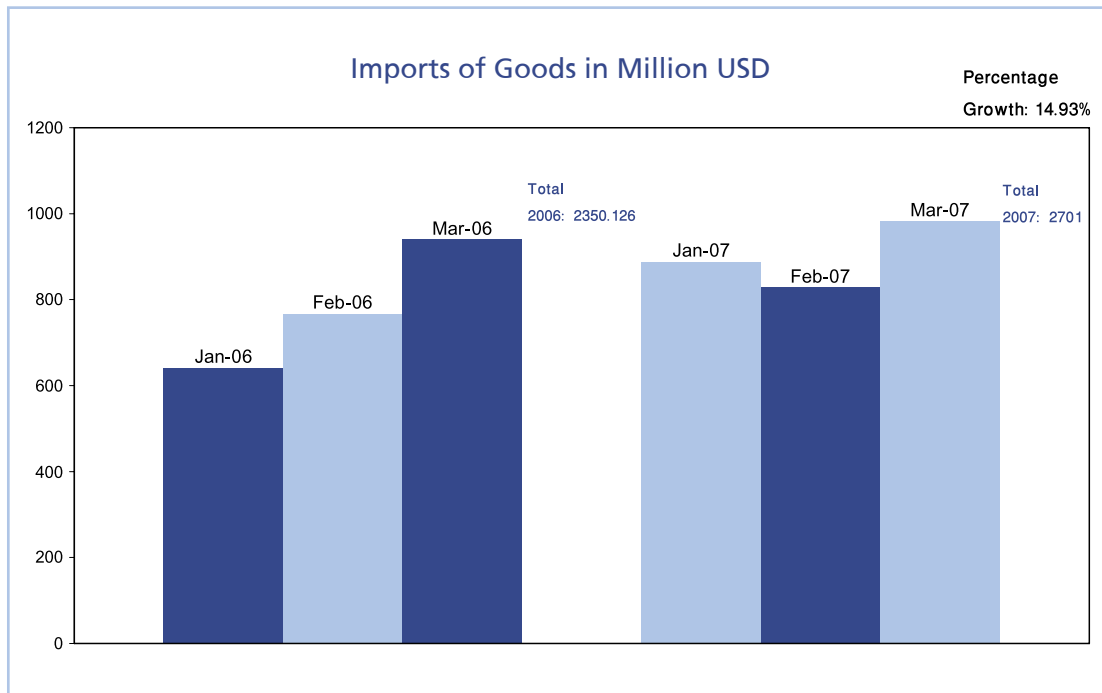
The trade balance shrank in 2006 as a result of climbing exports and steady imports, and recorded a deficit of \$7117 billion, down from \$7460 billion in 2005. Strong capital inflows, however, due to continued transfers from abroad and support from Arab countries and donors, caused a balance of payment surplus of \$2794 million in 2006, up from \$747 million in 2005.



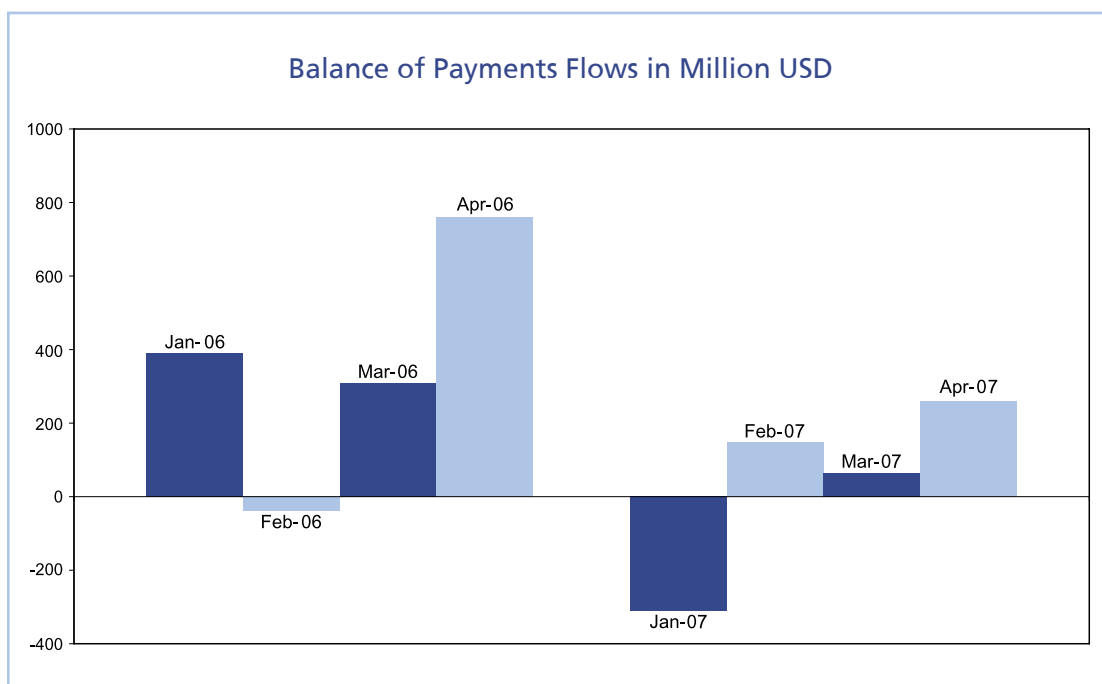
As for developments in 2007 so far, exports continued to provide a decent support to economic growth in the first quarter, increasing by 20% to \$622 million, in comparison with \$517 million in the first quarter of 2006.



Imports also edged up, driven by imports of vegetable products and prepared foodstuffs. Imports of articles of stones, plaster and cement, base metals and machinery and mechanical appliances also increased due to the reconstruction activity. As a result, total imports in the first quarter of 2007 increased by 15% to \$2701 million from \$2350 million in the first quarter of 2006.



The balance of payments has shown a surplus of around \$161 million in the first four months of 2007 in comparison with a surplus of \$1421 million in the first four months of 2006 when solid foreign direct investment flows, especially in the construction and tourism sectors, were being recorded.



Notwithstanding the weak economic activity in 2006, prices increased by 6.8%. This was mostly driven by shortages of goods and services that were witnessed during the war and to a significant increase in the price of housing and general services.

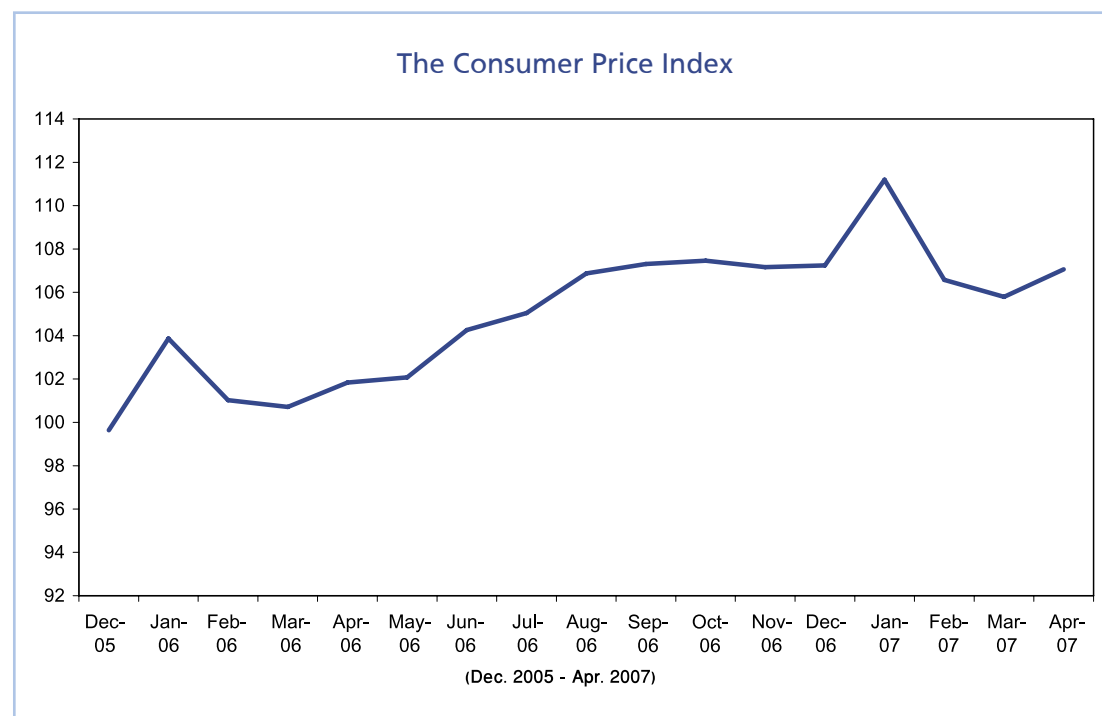
Consumer Price Inflation, 2006

(% change, year on year)

Food and beverages	11.7
Housing services	59.0
Transportation	4.1
Healthcare	2.8
Education	1.6
General services	10.2
Miscellaneous expenses	4.2
Housing	-0.5
Durable goods	-0.1
Total	6.8

Sources: Local press reports; Consultation and Research Institute

But the CPI declined in the first month of 2007, completely reversing the up-tick witnessed in the last months of 2006. As of end-April 2007, the CPI level was 107.06, compared with a level of 107.24 recorded as of end-December 2006.

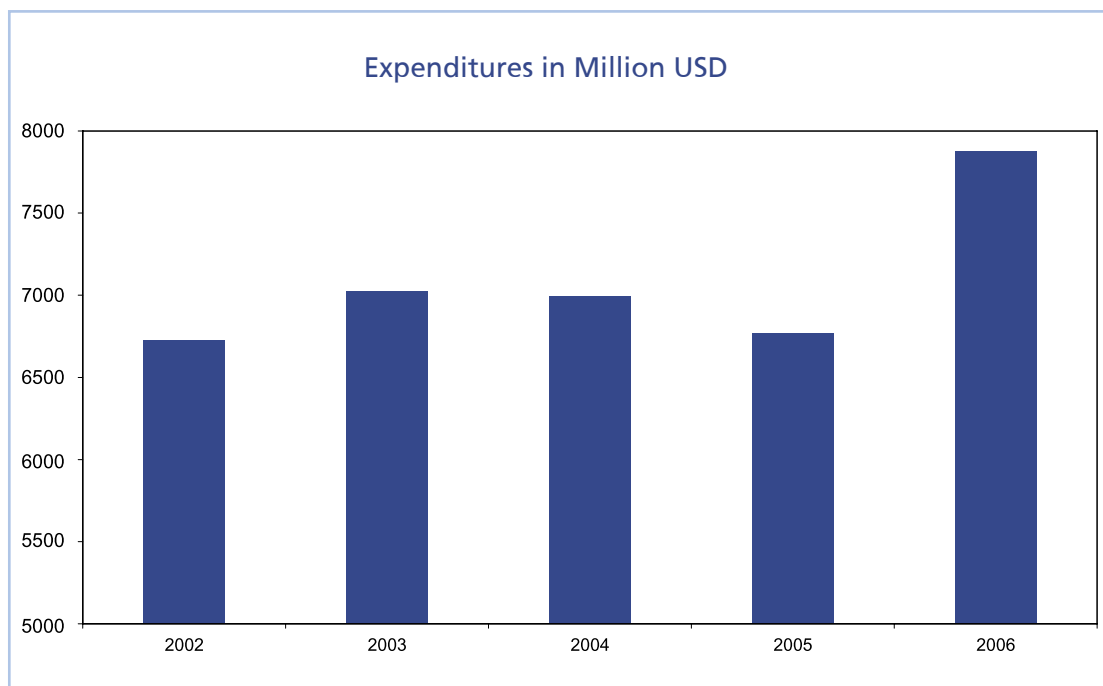
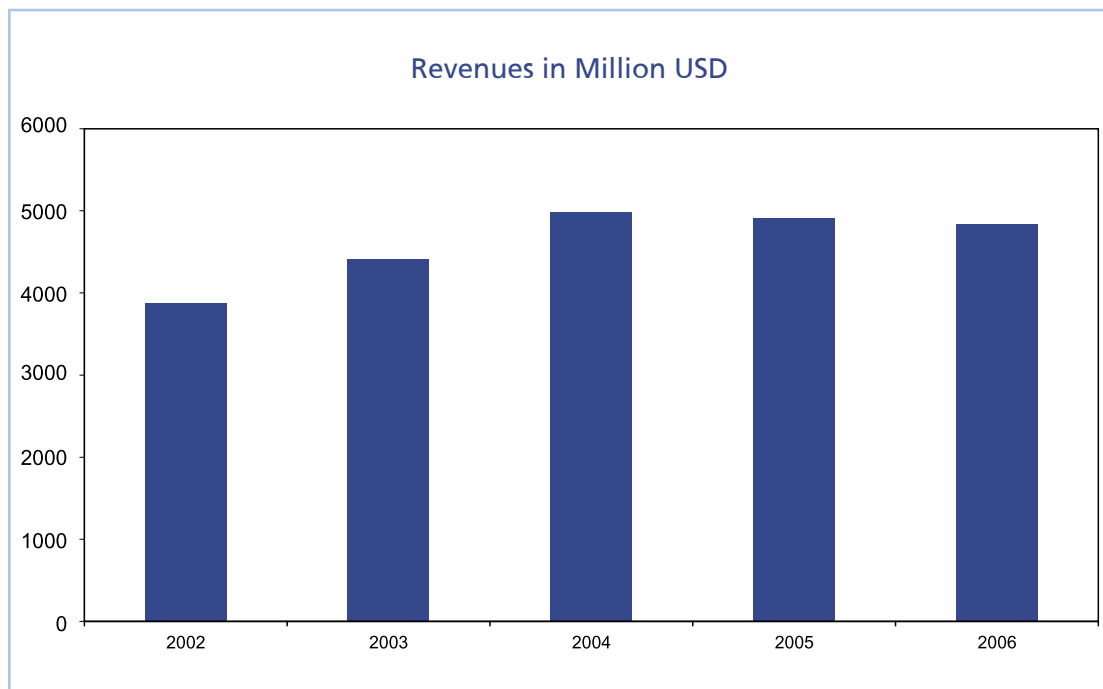


To summarize indicators of economic activity for 2007, it is obvious that the expected V-shape recovery in 2007 has failed to materialize so far. Bright spots such as exports are not big enough to compensate for the overall weakening of confidence. Even in construction, while cement deliveries have continued their solid growth, construction permits have slipped, suggesting a wait-and-see attitude from the part of big investors. On the positive side, prices have reversed their 2006 increases.

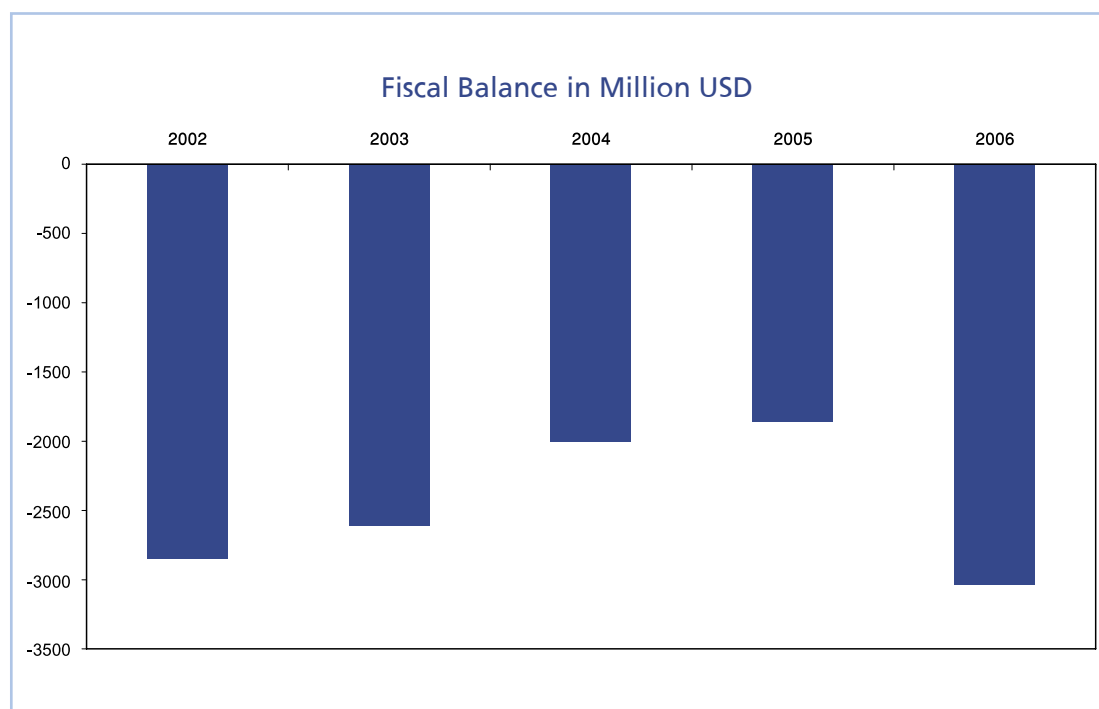
PUBLIC FINANCES

Public finances suffered a setback in 2006 on the back of declining revenues, caused by the lower level of economic activity, and on the back of higher expenses, caused by the higher transfers to the public electricity company and higher debt service payments.

Total revenues declined 1.5% from around \$4.9 billion in 2005 to around \$4.8 billion in 2006, while total expenditures increased 16.4% from around \$6.8 billion in 2005 to \$7.9 billion in 2006.



As a result, the overall deficit increased by 63.8%, from a deficit of around \$1.8 billion in 2005 to a deficit of around \$3 billion in 2006. This is corresponding to an increase in the deficit from 27.4% of expenditure in 2005 to 38.6% of expenditures in 2006, or in other terms, from around 8% of GDP in 2005 to around 13% of GDP in 2006.



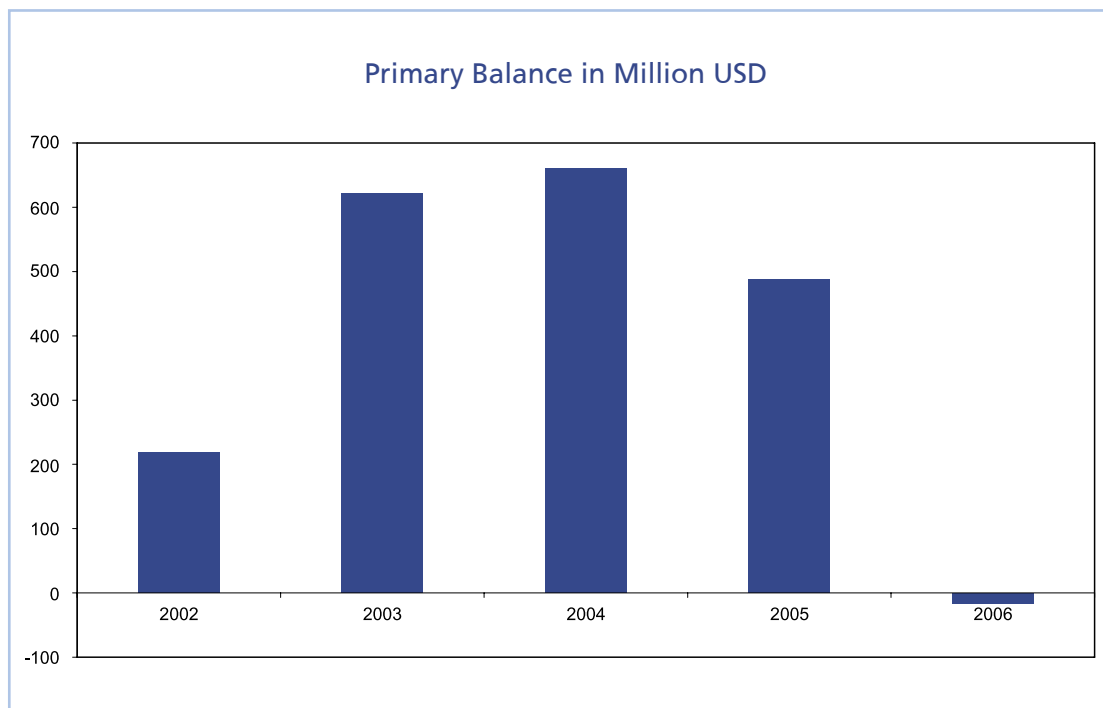
The decline in total revenue was caused primarily by a decline in the value added taxes, the taxes on international trade, as well as by a decline in revenue contributed by the telecom sector given the decrease in cellular phone usage during the war as economic activity halted.

Revenues (LBP billion)	<i>2005</i> <i>Jan-Dec</i>	<i>2006</i> <i>Jan-Dec</i>
Total Revenue	7,405	7,295
of which Tax Revenues	4,867	4,922
on Income, Profits & Capital Gains	1,047	1,166
on Property	414	579
on Value Added Tax	1,693	1,659
on International Trade	1,268	1,074
of which Non-Tax Revenues	2,117	1,945
Transfer from the Telecom Surplus	1,456	1,298

The increase in expenditures of around \$1.1 billion between 2005 and 2006 was mostly due to an increase in transfers to the public electricity company by about \$537 million and an increase in debt service by around \$1 billion.

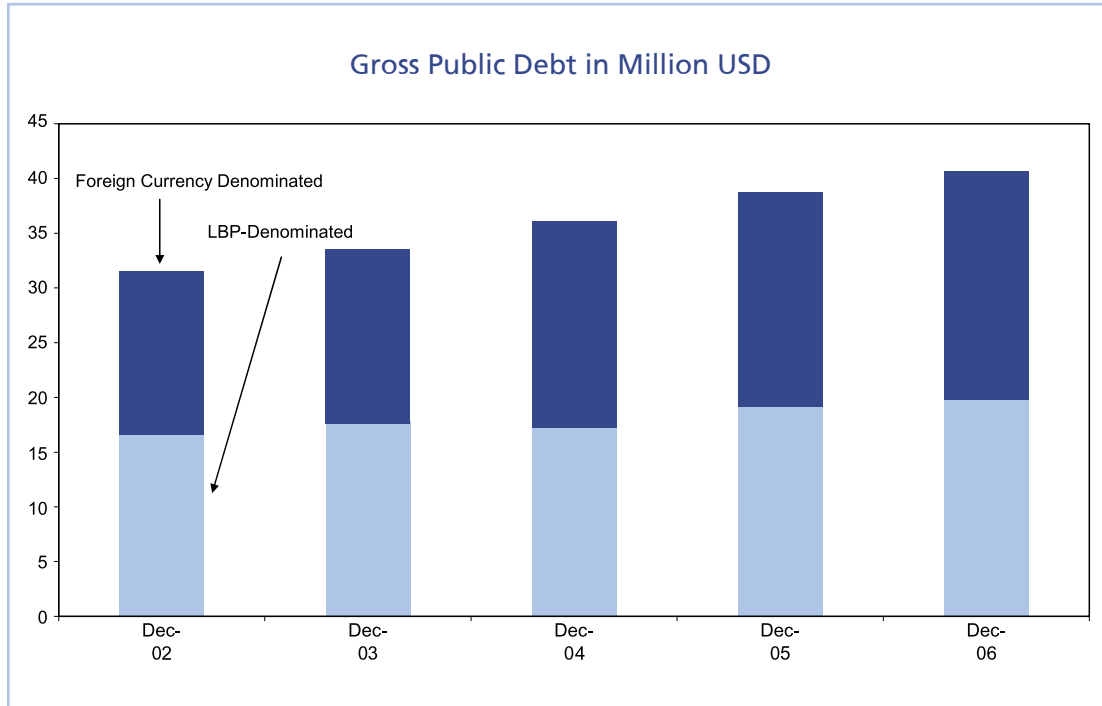
Expenditures <i>(LBP billion)</i>	<i>2005</i> <i>Jan-Dec</i>	<i>2006</i> <i>Jan-Dec</i>
Total Expenditures	10,203	11,877
of which Salaries and Wages	2,129	2,188
of which Debt Service Payments	3,534	4,557
of which Transfers to EDL	833	1,370

The non-interest expenditures (including transfer to EDL) increased by around \$430 million, causing the primary balance to turn from a surplus of around \$490 million in 2005 to a deficit of around \$17 million in 2006.



Gross public debt, as a result of a worsening fiscal situation increased by 5% from \$38.5 billion at end 2005 to \$40.4 billion at end 2006. The debt is now equally divided between local currency debt and foreign currency debt.





Public finances in the first four months of 2007 did deteriorate over the comparable period in 2006. Revenues increased by around 9% from the corresponding figure in 2006, expenditures increased by 23%, and the deficit increased by 89%, while the primary surplus shrank by around 36%.

Fiscal Results 1st Four Months: 2006 vs. 2007 (in Million USD)

	<i>As of April 2006</i>	<i>As of April 2007</i>	<i>%</i>
Total Revenue	1840	2003	8.83
Total Expenditure	2226	2734	22.79
Fiscal Balance	386	731	89.35
Primary Balance	517	330	-36.15

The official overall 2007 budget figures (released in May), point to the fact that the final outcome for 2007 will be a higher deficit than that of 2006. According to the draft budget approved by the government and to be sent to the parliament once it convenes, total expenditures are expected to be \$9041 million, a 14% increase over last year's realized expenditures. Most of the increase in expenditures results from an increase in capital expenditures, necessary security and army-related expenditures, as well as from an increase in debt service payments. Meanwhile, revenues are expected to total \$5091 million, a 6% increase over the realized revenue in 2006. This will put the deficit at around \$3.9 billion, compared with \$3 billion (realized) in 2006. The government, as a result, intends to ask parliament permission to borrow up to \$3 billion from the market, as the rest would be covered by Paris III budget support pledges by donors.

According to these figures, the gross public sector debt would then reach around \$43.5 billion, or 184% GDP by the end of 2007. But in the program that the government

signed with the IMF in the context Paris III, the IMF staff report expects a decline in the public sector debt both in nominal terms and as percent of GDP. The reason, according to the program, is that around \$1.6 billion in debt would be retired from the Treasury bills holdings of the central bank. According to the IMF program, these Treasuries will not be retired by cash payment from the government, but instead will be written off by the central bank as a form of transferring to the government, the unrealized valuation gains of gold held at the BDL. While the Lebanese law provides for such transfer, an informal agreement between the ministry and the BDL had suspended such transfers for three years.

In any event, the debt level has already reached \$41.3 billion by the end of April 2007 according to the figures published by the Ministry of Finance. It would be too early to conclude, at this stage, by how much further the debt level would increase by the end of 2007. The Ministry of Finance may decide to delay the receipt of valuation gains in gold to a time when market conditions are more averse. On the other hand, the Ministry may manage to transform, through negotiations, more support from Paris III to budget rather than capital expenditure support.

Regardless of the level of the debt that would materialize at the end of this year, a large amount of this debt is amortizing over the remaining months of 2007 and in 2008. In fact, most of the gross public debt that is denominated in LBP, i.e. around \$20 billion is coming due mostly between 2007, 2008 and 2009.



Projected Monthly Maturities of Outstanding TB's Portfolio Denominated in LBP as of April 30, 2007 (billion LBP)

Year	Month	Category								Total
		3m	6m	12m	24m	36m	48m	54m	60m	
2007	May-07	1	41	57	15	201				315
	Jun-07		37	329	141	160				667
	Jul-07	17	542	55	169	546				1329
	Aug-07		716	246	62	450				1474
	Sep-07		512	131	79	742				1464
	Oct-07		193	84	13	228				518
	Nov-07			71	84	906				1061
	Dec-07			11	56	824				891
Total		18	2041	984	619	4057				7719
2008	Jan-08			57	28	302				387
	Feb-08			112	48	1,281				1,441
	Mar-08			83	38	835		616		1,572
	Apr-08			7	41	858				899
	May-08				56	849				905
	Jun-08				101	1,123				1,224
	Jul-08				30	793			650	1,473
	Aug-08				34	696				730
	Sep-08				176	237				413
	Oct-08				333	351				684
	Nov-08				14	735				749
	Dec-08				26	629				655
Total				259	925	8,689		616	650	11,139
2009	Jan-09				180	697				877
	Feb-09				69	582				651
	Mar-09				251	753	298			1302
	Apr-09				236	405	335			976
	May-09					479				479
	Jun-09					558				558
	Jul-09					323				323
	Aug-09					632				632
	Sep-09					988				988
	Oct-09					1187				1187
	Nov-09					417				417
	Dec-09					734				734
Total					736	7755	633			9124
2010	Jan-10					234				234
	Feb-10					274				274
	Mar-10					192			203	395
	Apr-10					265			919	1184
Total						965			1122	2087
2011	Mar-11								400	400
Total									400	400
Portfolio		18	2041	1243	2280	21466	633	616	2172	30,469

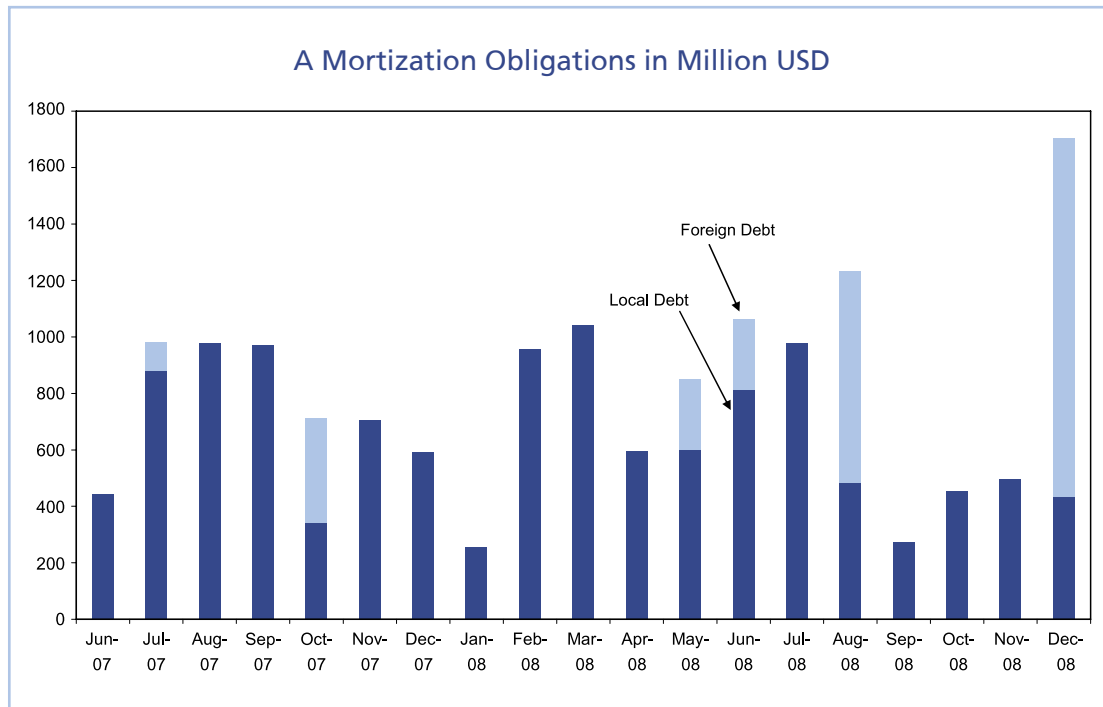
In addition, most of the non-LBP debt is in the form of Eurobonds, i.e. market traded sovereign debt denominated in foreign currency, mostly USD and euro.

**Projected Monthly Maturities of Outstanding Market Debt
Denominated in FC (million USD) as of April 30, 2007**

Jul-07	100
Oct-07	369
May-08	250
Jun-08	250
Aug-08	750
Dec-08	1,269
May-09	307
Aug-09	352
Oct-09	636
Nov-09	625
Dec-09	425
Mar-10	1,265
Nov-10	300
May-11	1,000
Aug-11	450
Apr-12	443
Sep-12	600
Jun-13	250
Apr-14	677
Jan-16	750
May-16	400
Dec-17	2,820
Mar-18	700
May-18	200
Apr-21	2,092

A monthly amortization schedule shows that around \$15 billion are coming due from now until the end of 2008, \$12 billion as Lebanese pound denominated debt and around \$3 billion as foreign currency denominated debt.





Bridging this financing gap would depend on two very important factors: (1) the willingness of the domestic commercial banks to rollover their Treasury bills holdings, and (2) the implementation of the Paris III reform agenda which would enable the government to collect commitments of funding in the form of grants and loans from the donors' community. The willingness of the banking sector to rollover obligations, let alone finance new needs, depends a great deal on the growth prospects of its balance sheet, which we discuss in the next section. As for Paris III, we discuss it in detail in the appendix at the end of the report.



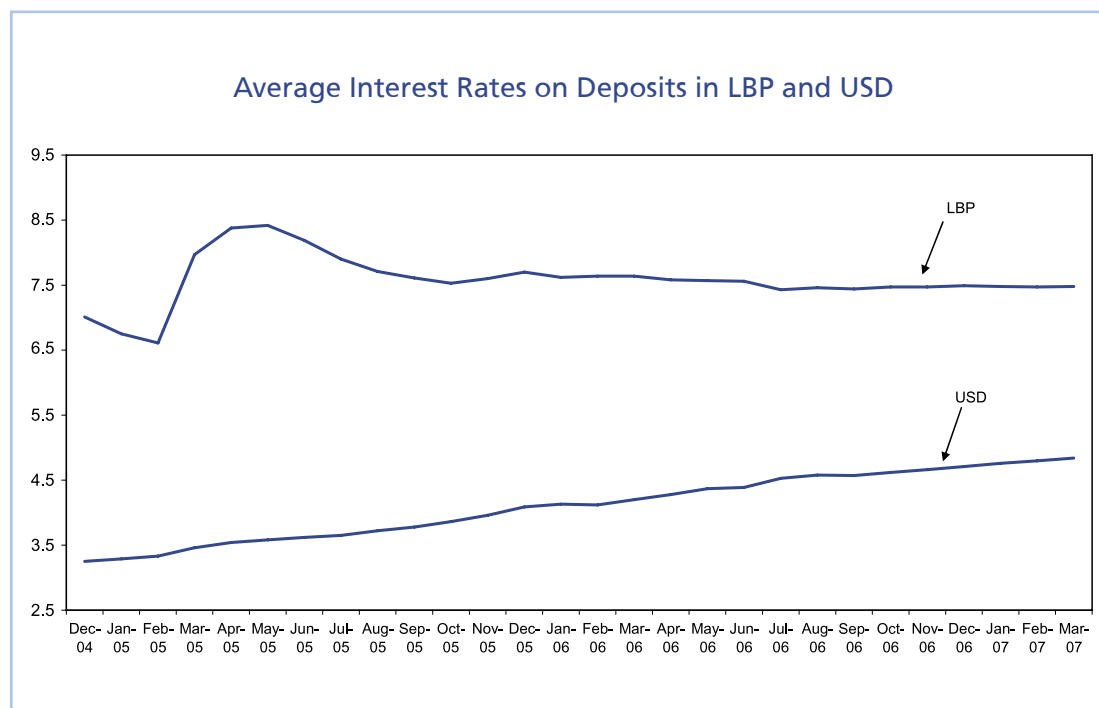
BANKING SECTOR AND FINANCIAL MARKETS

The banking sector has shown strong resilience, and an ability to grow under very difficult circumstances. This was accomplished by continued overseas expansion as well as by an aggressive move towards retail products domestically. Total assets grew by over 8% in 2006 to reach over \$76 billion. This was underpinned by an increase in total deposits by 6.5% to reach over \$70 billion. Loans to the private sector increased by 6% to exceed \$17 billion while total foreign assets of the commercial banks increased by 24% to reach over \$16.4 billion, over 70% of GDP, one of the highest ratios in the world. Profits reached an all time high of around \$700 million.

	LBP Billion		USD Billion		Dec/Dec %
	Dec. 05	Dec-06	Dec. 05	Dec-06	
Assets					
Deposits at BDL	30716	29137	20.375	19.328	-5.141
Claims on Private Sector	24467	25930	16.230	17.201	5.979
in LBP	4306	4768	2.856	3.163	10.729
In USD	20161	21162	13.374	14.038	4.965
Claims on Public Sector	26697	31193	17.709	20.692	16.841
in LBP	12666	15101	8.402	10.017	19.225
In USD	14030	16091	9.307	10.674	14.690
Foreign Assets	20017	24784	13.278	16.440	23.815
Claims on Non-Residents Banks	15791	18446	10.475	12.236	16.813
Liabilities					
Resident Private Sector Deposits	71632	77366	47.517	51.321	8.005
in LBP	22042	21081	14.622	13.984	-4.360
In USD	49590	56285	32.896	37.337	13.501
Public Sector Deposits	1705	1579	1.131	1.047	-7.390
Non-Residents Deposits	14274	14128	9.469	9.372	-1.023
in LBP	1038	682	0.689	0.452	-34.297
In USD	13236	13446	8.780	8.919	1.587
Deposits of Non Residents Banks	3263	4236	2.165	2.810	29.819
Capital Account	6411	8718	4.253	5.783	35.985
Balance Sheet (Assets=Liabilities)	106015	114840	70.325	76.179	8.324

Source: BDL

The liquidity in the banks allowed them to keep their interest rates on deposits in LBP stable, despite the fact that global interest rates rose. Historically, rising US interest rates have tended to feed into the Lebanese interest rate as a result of the peg. Despite this, and despite the negative political and security environment in 2006 and 2007, interest rates on LBP deposits have edged slightly down, and rates on USD deposits have edged slightly up, rather than significantly up like their global counterparts, due to the large inflows into the financial system which came in first as foreign direct and portfolio investments in the first half of 2006 and as international aid and assistance in the second half of 2006 and early 2007.



As a matter of fact, the liquidity position at the commercial banks has always supported their willingness to rollover the government's amortization obligations. But the growth in assets was a bit sluggish in the first four months of 2007 when compared with the first four months of 2006. Assets in the first four months of 2006 grew by 1.1% compared with a 4.2% growth in the comparable period in 2006. This was accompanied by a slight reduction in the absorption of public debt by the banks. Claims on public sector decreased by 2.5% in the first four months of 2007 while they increased by 12.2% in the first four months of 2006. This in turn has been partly offset by the government through the reduction of public sector deposits in the banks, which shrank by over 27% in the first four months of 2007.

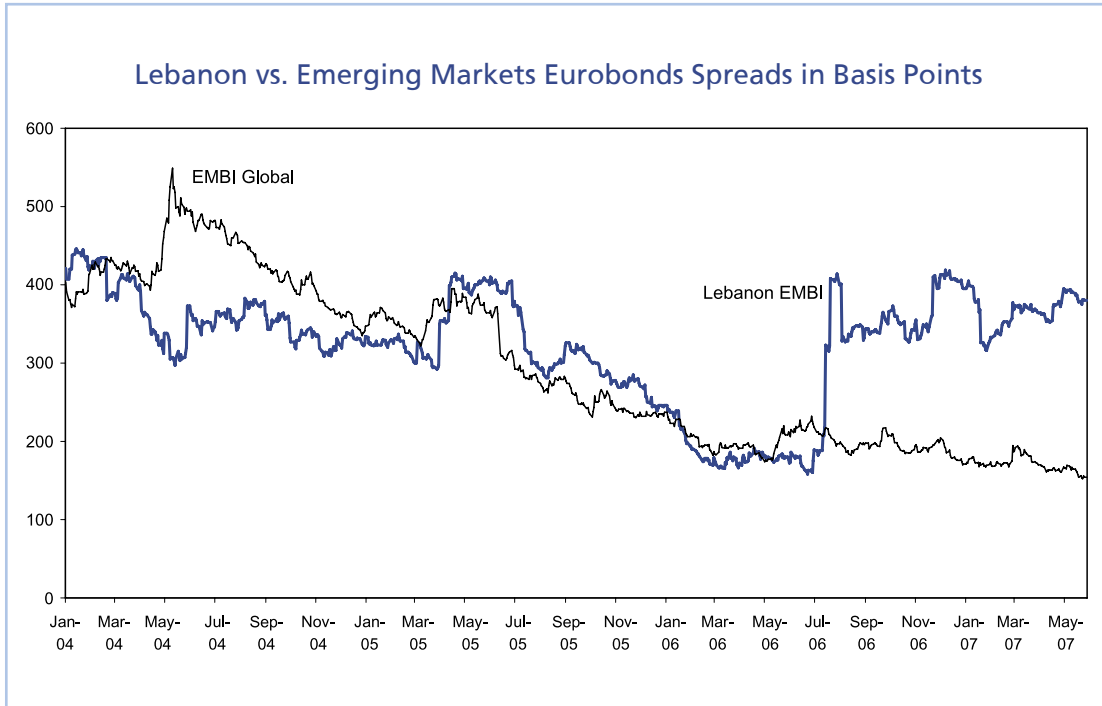
Private sector deposits increased by 1.9% or by \$1.2 billion in the first four months of 2007, and reached \$61.9 billion. This compares with an increase of 3.1% or by \$1.8 billion in the first four months of 2006. Residents' deposits have increased by 3.6% in the first four months of 2007, and reached \$53 billion. This is in line with their increase by 3.3% in the first four months of 2006. Non-residents' deposits, however, have declined by around 7% in the first four months of 2007 as opposed to an increase of 2.9% in the first four months of 2006.

Consolidated Balance Sheet of Lebanese Commercial Banks

	USD Billion					
	Dec-05	Apr-06	%	Dec-06	Apr-07	%
Assets						
Deposits at BDL	20.375	19.720	-3.217	19.328	19.955	3.243
Claims on Private Sector	16.230	16.785	3.417	17.201	17.813	3.560
in LBP	2.856	2.991	4.714	3.163	3.240	2.454
In USD	13.374	13.794	3.140	14.038	14.573	3.813
Claims on Public Sector	17.709	19.885	12.282	20.692	20.174	-2.501
in LBP	8.402	9.690	15.332	10.017	9.584	-4.324
In USD	9.307	10.194	9.530	10.674	10.590	-0.783
Foreign Assets	13.278	14.083	6.060	16.440	16.246	-1.182
Claims on Non-Residents Banks	10.475	10.560	0.811	12.236	11.476	-6.213
Liabilities						
Resident Private Sector Deposits	47.517	49.114	3.360	51.321	53.164	3.592
in LBP	14.622	15.478	5.857	13.984	14.456	3.373
In USD	32.896	33.636	2.250	37.337	38.708	3.674
Public Sector Deposits	1.131	1.171	3.578	1.047	0.758	-27.676
Non-Residents Deposits	9.469	9.753	2.998	9.372	8.712	-7.043
in LBP	0.689	0.641	-6.936	0.452	0.468	3.519
In USD	8.780	9.112	3.778	8.919	8.243	-7.578
Deposits of Non Residents Banks	2.165	1.999	-7.662	2.810	2.724	-3.045
Capital Account	4.253	4.795	12.759	5.783	5.914	2.260
Balance Sheet (Assets=Liabilities)	70.325	73.290	4.215	76.179	77.020	1.104

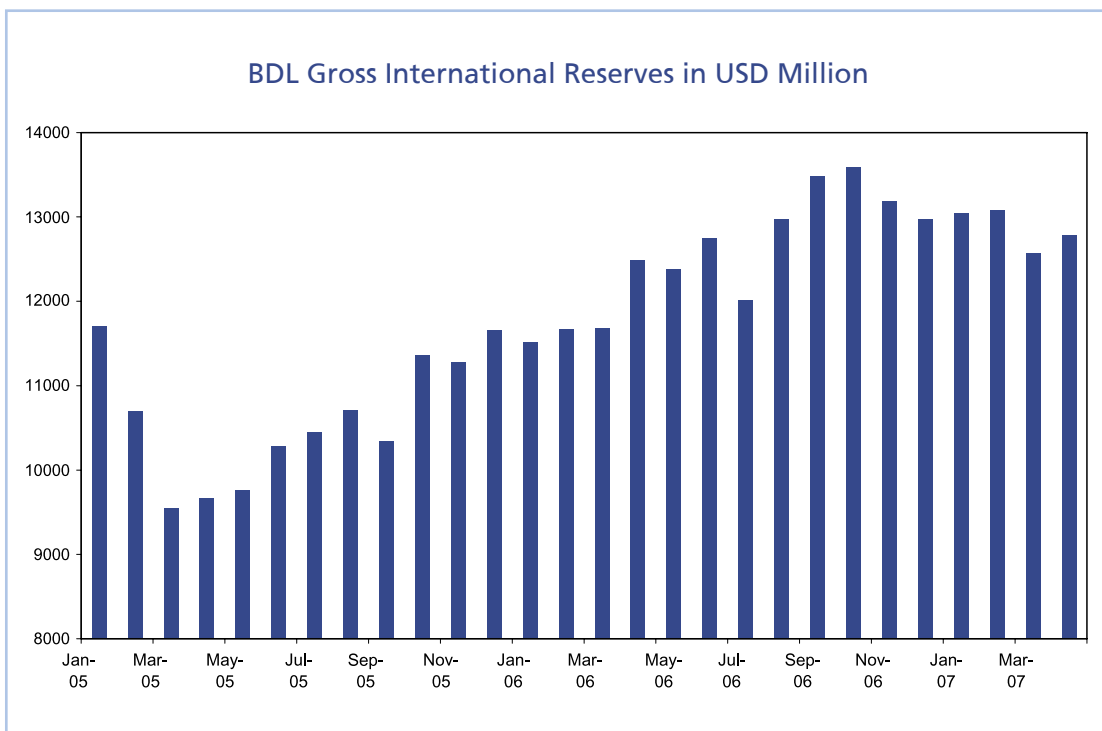
Source: BDL

The financial sector has been affected by the summer 2006 events as well as by the political problems that ensued. Spreads on Lebanese Eurobonds did diverge from the Emerging Markets Bond Index or EMBI global spreads, which capture the average for all emerging markets. Lebanon EMBI spreads are at around 380 basis points over equivalent US treasuries (as of end-May 2007), while emerging markets spreads are around 155 basis points over corresponding US treasuries as of end-May 2007. This means a higher borrowing cost for Lebanon on the international capital markets.



The government reopened a bond issue maturing in 2013, and issued an additional \$400 million in external debt. The deal, rated B3 by Moody's, was priced to yield 8.75%, or just 397 bps over US treasuries. The sale was the sovereign's first since the 2006 conflict, and was sold despite ongoing security concerns. Credit default protection on the sovereign was trading at around \$336,000 per year for \$10 million of cover at the time of the sale at end-May.

Meanwhile, risk to the exchange rate remains minimal given a comfortable level of gross international reserves which totaled around \$12787 million (excluding gold) as of end April 2007.



The stock market has also been showing resilience to various political and security shocks. Most shares trading on the Beirut Stock Exchange has been range-bound over the last year or so.

Listed Securities	Closing Price (USD)	
	28-DEC-06	20-JUN-07
Solidere A	16.00	16.11
Solidere B	16.00	16.25
Bank Audi- GDR	55.95	60.00
Byblos Bank	1.81	1.78
Byblos Bank priority	1.81	1.81
BLOM Bank GDR	57.65	66.00
Holcim Liban	1.78	1.95
Market Capitalization (in USD)	8,305,164,511	8,402,048,522



THE BOTTOM LINE

The final figures for 2006 reflect mixed economic performance. The real economic growth rate was zero and inflation picked up to 7% on supply shortages caused by the July war. Nominal GDP reached \$22.6 billion rather than the \$23.9 billion expected prior to the July war. External sector figures, however, reflected a notable increase in exports, and solid balance of payments inflows. Public finances deteriorated, mostly due to the effects of the July war, and the deficit increased to \$3 billion, i.e. around 39% of expenditures or 13% of GDP. The gross public debt increased, as a result, to \$40.4 billion, or 179% of GDP. Meanwhile, commercial banking sector assets grew by over 8% to exceed \$76 billion, or 3.5 times GDP, one of the highest ratios of the world, and banking sector profits reached a record high of over \$700 million.

As anticipated, 2007 continues to be a difficult transition year beset by dragging political uncertainty. The year is expected to witness a pick up in economic growth to around 2%, mostly due to post-war reconstruction. This expected figure, however, is highly volatile as the final outcome is heavily dependant on how the political and security situations evolve. What one can claim for sure is the fact that the widely expected V-shape recovery was delayed as political divisions that emerged at end 2006 and continued through 2007 severely affected the business environment. A deterioration of the security situation in June is likely to have already compromised the summer season, usually an important contributor to growth in the tourism-dependent Lebanese economy. Inflation, however, has abated, and probably will not exceed 2% in 2007. Exports are expected to continue their strong growth, benefiting from a weakening dollar against the euro. The fiscal deficit is expected to total around \$3.9 billion, but the financing requirement would be less due to Paris III pledges. Growth in banks assets and profitability are likely to continue as banks continue to expand overseas and shift towards more retail banking locally.

Large debt amortization obligations coming due in the next two years make a speedy implementation of the reform agenda a priority. Reducing the fiscal deficit through revenue and expenditures reform is essential to slow the accumulation of the debt in terms of flows, while privatization is key to reducing the debt level in terms of stock. While a program has been signed with the IMF to oversee the implementation of the reform agenda, the dragging of the political stalemate, and the lack of a broad national consensus on economic reforms continue to pose serious risk to the outlook in terms of debt dynamics.

Financial stability, anchored by a proactive central bank and a solid banking sector, seems to have been fostered. Domestic financial markets players have all factored in the political uncertainty and the recurrent outbreaks of violence. If anything, a conclusion of the political stalemate should see a rally in the Lebanese markets.

With all these economic, political, and security factors coming at play at once, it may be hard for some to see beyond the foggy crossroad that Lebanon is currently at. One should never forget, despite all, the huge upside potential that remains there. Should the political stalemate end, the country is set to capitalize on unprecedented regional demand driven by historically high oil prices and abundant liquidity. After all, it remains the one country in the Middle East with a combination of institutional framework, financial sector, and human capital that could ride the most on the oil boom, once politically-related risk dissipates.

APPENDIX 1

Pledges of the Rafic Hariri Donors Conference (Paris III)

- The international community gathered on January 25, 2007 in Paris, to support the Lebanese government reconstruction and reform agenda which was officially launched during the conference.
- Pledges totaled \$7.6 billion, of which around \$1109 were in the form of grants.
- Arab donors constituted 36% of the total, and European donors constituted 38% of the total, international donors constituted 12% of the total and International Financial Institutions constituted 14% of the total.
- Pledges were divided into 4 categories: (a) support to the government totaled \$5145 million or 68% of the total, (b) private sector support was \$1510 million or 20% of the total, (c) projects underway were \$874 million or 11% of the total, and (d) 76 million or 1% remain under discussion. .
- The government received so far the \$300 million soft loan provided by the UAE.
- The funds dedicated to support the private sector are mostly in the form of soft loans targeted towards small and medium size companies.

The table below summarizes the pledges of Paris III by donor and by category:

Paris III Pledges Over \$100 Million

Country	Total	Projects Under-way	Private Sector	UN System/ UNIFIL/	To BDL	Grant to Government		Loan to Government		Under review
						Budgetary Support	Project financing	Budgetary Support	Project financing	
EIB	\$1,248	\$260	\$709						\$280	
Saudi Arabia	\$1,100					\$100			\$1,000	
World Bank	\$975		\$275					\$300	\$400	
United States	\$890		\$120	\$185		\$586				
AFESD	\$750	\$300							\$450	
France	\$650		\$163					\$488		
EC	\$486	\$139				\$282		\$65		
UAE	\$300							\$300		
IDB	\$250	\$5					\$30		\$215	
AMF	\$250							\$250		
Italy	\$156						\$20		\$98	\$39
Germany	\$134	\$43					\$91			
UK	\$115	\$80		\$35						

APPENDIX 2

Main Elements of the Lebanese Government Reform Program

The Lebanese government presented in January 2007 its economic and social reform program in the context of the international donors' conference in Paris. The program revolves around five main pillars: Fiscal adjustment, Privatization, Monetary and exchange rate policies, Growth-enhancing structural reforms, and Social sector reforms. Most of the implementation would not start until 2008. The essential elements of each pillar are summarized below.

Fiscal adjustment consists of both revenue and expenditure measures.

Revenue measures include increasing the VAT rate from 10% to 12%, and the withholding tax on interest income from 5% to 7%, returning gasoline excises to their 2004 levels, introducing a global income tax (GIT), and reforming the tax administration.

Expenditure measures include containing the wage bill and other current expenditures, eliminating extra budgetary funds, and reducing transfers by reforming the power utility and the pension system. Capital expenditures will be temporarily increased for reconstruction. The government also intends to improve the budget process and debt management.

Privatization includes the two mobile phone operators and the fixed line telephone company. The central bank is expected to divest ownership of Middle East Airlines and Intra (a holding company which owns Casino du Liban).

Monetary and Exchange rate policies will focus on maintaining price stability through the exchange rate peg. The government will reduce its reliance on central bank financing to strengthen the independence of the BDL.

Growth enhancing structural reforms are designed to improve the business climate and competitiveness. They will: (1) address issues relating to governance, (2) streamline regulations, and (3) facilitate access to credit and deepen the capital markets.

Social sector reforms seek to alleviate poverty, reduce regional income disparities and improve education and health indicators. Measures will include rationalizing social spending across ministries, reforming the existing social safety net, introducing new pilot programs targeting the poor, and raising the effectiveness and coverage of health and education facilities.

General Economic Indicators

	2003	2004	2005	2006
Real GDP growth (in %)	4.1	7	1	0
inflation (in %)	2.2	2	0.5	6.8
GDP (in Billion \$)	19.8	21.4	21.4	22.6
Government Revenues (in Million \$)	4414	4985	4912	4838
Government Expenditures (in Million \$)	7026	6992	6768	7879
Deficit (in Million \$)	2612	2007	1856	3041
Deficit (in % of GDP)	13.2	9.2	8.4	13.4
Primary Balance (in Million \$)	621	660	489	-17
Primary Balance (in % of GDP)	3.1	3.0	2.2	0.0
Gross Public Debt (in Billion \$)	33.36	33.85	38.48	40.40
of which LBP (in Billion \$)	17.81	17.49	19.33	20.00
of which USD (in Billion \$)	15.55	16.36	19.15	20.40
Gross Public Debt (in % of GDP)	168	156	174	178
Export of Goods (in Million \$)	1525	1748	1880	2282
Imports of Goods (in Million \$)	7171	9400	9343	9398
Trade Deficit (in Million \$)	5646	7652	7463	7116
Trade Deficit (in % of GDP)	28.5	35.3	33.8	31.5
Current Account Deficit (in Million \$)	2625	3377	2517	1549
Current Account Deficit (in % of GDP)	15.3	18.3	12.6	6.9
Net Foreign direct investment (in Million \$)	1722	2333	2629	2724
Balance of Payments Flows (in Million \$)	3386	169	747	2795
BDL FC Reserves (in Million \$)	10213	9513	9845	12787
BDL FC Reserves (in % of M2)	56	52	61	82

Source: IMF, Ministry of Finance and BDL

Total Imports & Exports By Product (Million US Dollars)

Goods	Imports		Exports	
	2005	2006	2005	2006
Live animals, animal products	428	444	9	12
Vegetable products	384	366	77	80
Fats & edible fats & oils	83	94	14	12
Prepared foodstuffs	530	534	191	187
Mineral products	2,226	2,413	126	86
Products of the chemical	820	887	163	162
Plastic & articles thereof	357	361	78	85
Raw hides & skins, leather, furskins	42	41	14	14
Wood and articles of wood	136	127	22	19
Paper & paperboard & articles thereof	264	242	116	134
Textiles and textile articles	486	464	82	87
Footwear, headgear, prepared feathers	66	70	18	15
Articles of stone, plaster, cement	163	148	52	48
Pearls, precious stones and metals	491	291	224	555
Base metals and articles of base metal	651	682	276	321
Machinery & mechanical appliances	1,061	1,123	314	334
Transport equipment	809	764	22	34
Optical instruments & apparatus	160	184	17	20
Arms and ammunition	6	3	0	0
Miscellaneous manufactured articles	171	155	58	70
Works of art	7	6	9	10
Total	9,340	9,398	1,880	2,283

Source: Directorate General of Customs



Imports By Origin (Million US Dollars)

	2005	Share %	2006	Share %
USA	548	5.9	1,016	10.8
Italy	976	10.4	710	7.6
China	734	7.9	752	8.0
France	788	8.4	761	8.1
Germany	657	7.0	660	7.0
Egypt	303	3.2	379	4.0
UK	323	3.5	407	4.3
Saudi Arabia	329	3.5	296	3.1
Turkey	200	2.1	258	2.7
Brazil	160	1.7	227	2.4
Other Countries	4,322	46.3	3,932	41.8
Total imports	9,340	100	9,398	100

Source: Directorate General of Customs

Exports By Destination (Million US Dollars)

	2005	Share %	2006	Share %
Switzerland	125	6.6	451	19.8
Syria	187	9.9	176	7.7
UAE	155	8.2	176	7.7
Saudi Arabia	140	7.4	146	6.4
Turkey	122	6.5	102	4.5
Iraq	178	9.5	136	6.0
Egypt	55	2.9	48	2.1
Jordan	75	4.0	84	3.7
Belgium	23	1.2	47	2.1
Qatar	36	1.9	64	2.8
Other Countries	784	41.7	853	37.4
Total Exports	1,880	100.0	2,283	100.0

Source: Directorate General of Customs

Fiscal Performance Summary (LBP Million)

	2003	2004	2005	2006
1. Budget Transactions				
Revenues	6,218,603	7,075,268	6,984,222	6,867,491
Tax Revenues	4,501,871	5,168,747	4,866,834	4,922,218
Tax Revenues other than customs and VAT	1,498,823	1,788,976	1,905,860	2,189,561
Customs Revenues	1,642,051	1,616,573	1,267,578	1,073,924
VAT Revenues	1,360,997	1,763,198	1,693,396	1,658,733
Non Tax Revenues	1,716,732	1,906,521	2,117,388	1,945,273
Expenditures	8,809,828	8,305,821	7,802,216	8,640,901
Expenditures excluding debt service	3,935,463	4,284,335	4,267,913	4,084,093
Debt Service	4,874,365	4,021,486	3,534,303	4,556,808
Domestic Debt	3,107,903	2,245,915	1,532,600	2,368,158
Foreign Debt	1,766,462	1,775,571	2,001,703	2,188,650
2. Treasury Transactions				
Receipts	435,857	438,978	421,251	427,365
Trust accounts/Guarantees	180,117	94,238	74,595	68,809
Municipalities	116,018	108,878	187,172	137,408
Deposits	46,880	72,018	66,278	74,244
Other	92,842	163,844	93,206	146,904
Payments	1,782,587	2,234,615	2,401,059	3,235,648
Trust accounts/Guarantees	250,757	566,869	894,486	504,116
Municipalities	179,763	460,664	384,188	404,778
Deposits	81,385	69,175	73,663	59,669
Previous years appropriations	609,733	526,493	647,720	655,835
Previous years/Guarantees	129,654	92,685	27,477	26,806
Other	531,295	518,729	373,525	1,584,444
3. Total Budget and Treasury Receipts	6,654,460	7,514,246	7,405,473	7,294,856
4. Total Budget and Treasury Payments	10,592,415	10,540,436	10,203,275	11,876,549
5. Total Deficit/Surplus (cash basis)	-3,937,955	-3,026,190	-2,797,802	-4,581,693
6. Total Primary Deficit/Surplus	936,410	995,296	736,501	-24,885

Source: Ministry of Finance

Gross Public Sector Debt Outstanding

	Dec. 03	Dec. 04	Dec. 05	Dec. 06
in LBP Billion				
Total Gross Public Debt	50,285	54,048	57,985	61,000
Domestic Debt	26,843	26,371	29,141	30,204
a. Central Bank (including REPOs and Loans to EDL)	8,938	10,652	11,686	9,588
b. Commercial Banks	12,303	12,220	14,130	16,487
c. Other Domestic Debt (T-Bills)	5,603	3,500	3,325	4,129
o/w Public entities	2,564	2,187	2,446	3,313
Foreign Debt	23,442	27,677	28,877	30,798
a. Bilateral Multilateral Foreign Private sector loans	2,934	2,970	2,822	3,006
b. Paris II Related debt (Eurobonds and Loans)	3,731	3,814	3,682	3,721
c. BDL Eurobond (Paris II)	2,819	2,819	2,819	2,819
d. Market Eurobonds	13,631	17,686	18,729	20,399
e. Accured Interest on foreign currency debt	327	388	406	434
f. Special T-Bills in Foreign currency			419	419
in USD Billion				
Total Gross Public Debt	33.357	35.853	38.464	40.4643
Domestic Debt	17.806	17.493	19.331	20.0358
a. Central Bank (including REPOs and Loans to EDL)	5.929	7.066	7.752	6.3602
b. Commercial Banks	8.161	8.106	9.373	10.9367
c. Other Domestic Debt (T-Bills)	3.717	2.322	2.206	2.73897
o/w Public entities	1.701	1.451	1.623	2.19768
Foreign Debt	15.550	18.360	19.156	20.4299
a. Bilateral Multilateral Foreign Private sector loans	1.946	1.970	1.872	1.99403
b. Paris II Related debt (Eurobonds and Loans)	2.475	2.530	2.442	2.46833
c. BDL Eurobond (Paris II)	1.870	1.870	1.870	1.86998
d. Market Eurobonds	9.042	11.732	12.424	13.5317
e. Accured Interest on foreign currency debt	0.217	0.257	0.269	0.28789
f. Special T-Bills in Foreign currency			0.278	0.27794

Source: Ministry of Finance

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