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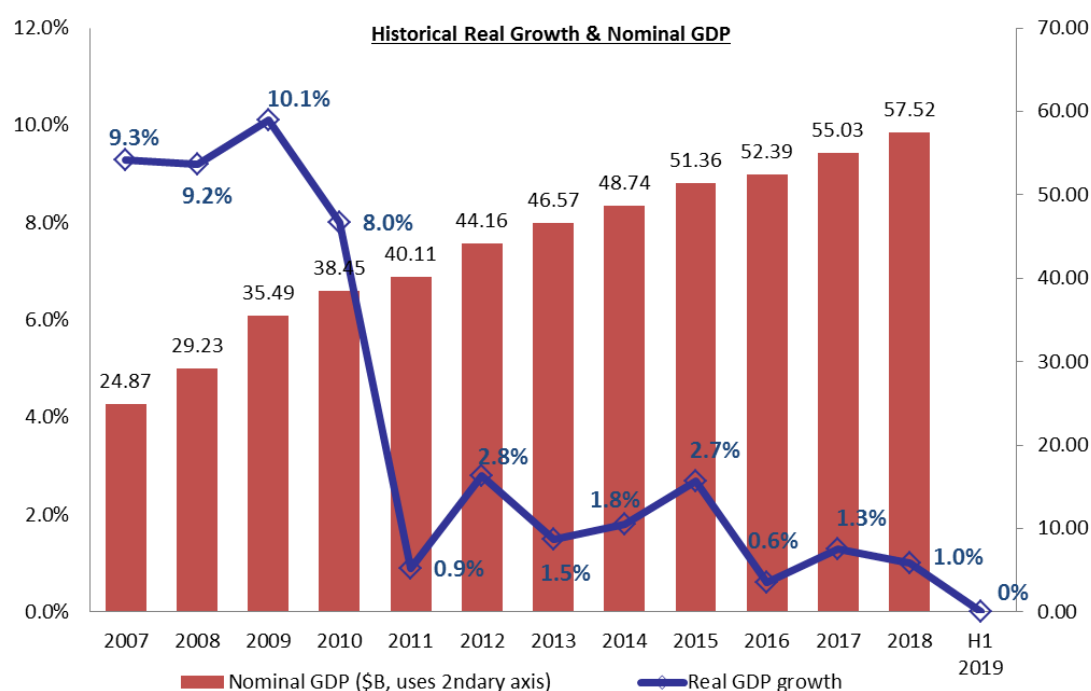
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Abstract

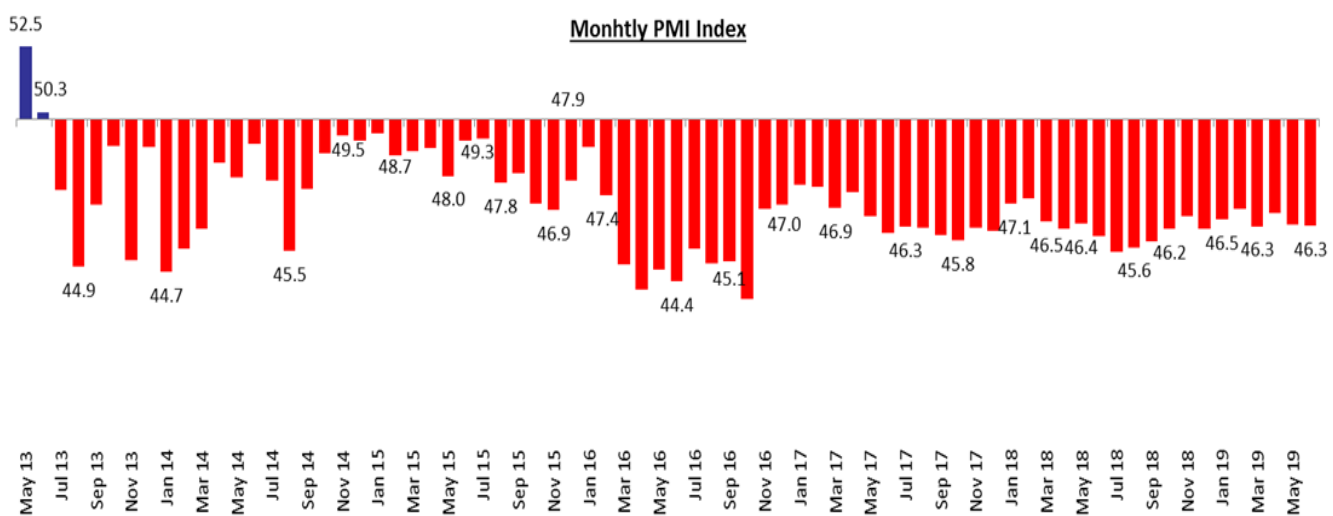
The study explores the macroeconomic indications of the Lebanese economy and therefore comes to update the findings of the similar report published in Sept. 2018 and to interpret the impact of national and regional developments on the Lebanese economy since then, to-date. While macro parameters remain weak amid an environment of subdued growth, the authorities exhibit a number of steps forward on the fiscal adjustment path.

Overview



Source: BLOMinvest's Estimates

Growth was subdued in H1 2019, as Lebanon's private sector refrained from investing in future businesses. Lebanon's economic growth stood at an estimated 0% in H1 2019. Economic growth was capped due to sectorial slowdowns as well as persisting crowding out of the private sector in the first half of the year due to high interest rates. In fact, the BLOM Purchasing Managers' Index (PMI), a predictive power¹ for economic growth, stalled at an average of 46.5 in H1 2019, compared to 46.6 and 47.1 in H1 2018 and 2017, respectively. The average PMI score in H1 2019 was underpinned by persisting pressures on private sector companies who adopted a wait-and-see approach as they monitor the political and economic reform plan to gradually materialize, stabilize the operating environment, and kick start their investment.



Source: BLOMinvest Bank; IHS Market

Activity in real estate & construction (19.2% of GDP) slumped noticeably mainly as a result of the subsidized loan schemes in March last year. From a sectorial perspective, real estate and construction, one of Lebanon's two growth drivers, markedly contracted by June 2019. The number of real estate (RE) transactions dropped by a substantial 20.07% year-on-year (YOY) to 21,957 transactions over the period, while the value of total RE transactions stood at \$2.73B, down by an annual 29.6% in H1 2019 compared to the softer 14.01% YOY decline recorded in H1 2018.

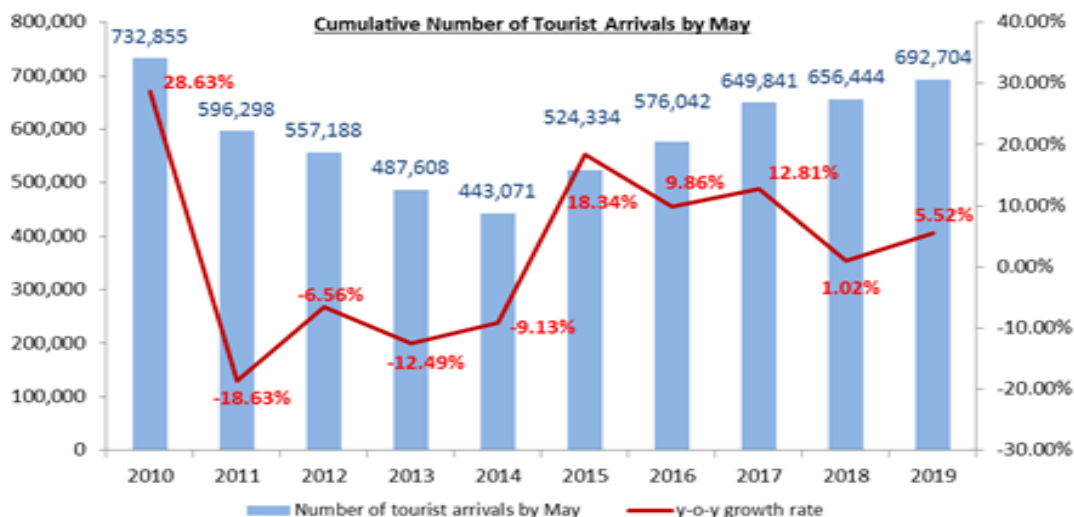
Moreover, despite BDL's effort to reactivate subsidized loans, property prices continued to contract which also weighed down on construction activity. Prices of sold properties continued to slide despite BDL's circular 515 (issued Jan 2019) in which it reactivated the subsidizing of housing loans program via banks and financial institutions. However, this was not enough to boost the sector with the value and number of construction permits extending their decline even though a total of LBP 790B was allocated to subsidize housing loans, of which LBP 490B were reserved to settle 2018 dues. As such, only LBP 300B were

¹ The BLOM Lebanon PMI (compiled by Markit) is an important "leading indicator" for the economy, given the absence/prolonged delays of quarterly and annual GDP data from national sources.

extended to support 2019 housing loans, with the loan ceiling set at LBP 450M per loan. Against this context, the latest data by the order of Engineers in Beirut and Tripoli revealed an annual 19.2% slump in the total number of construction permits to 4,927 by May 2019, compared to a softer 14.5% downtick registered by May 2018. The Construction Area Authorized by Permits by May 2019 stood at \$3.05M square meters, having slipped significantly by 30.58% YOY compared to an 18.6% YOY decline in the same period of 2018.

The slowdown in the real sector was also reflected in the decline of cleared checks and car sales.

The number and value of cleared checks fell to \$23.41B by May 2019, retreating by an annual 15.47% as per the Association of Banks. The total number of cleared checks lagged by 13.9% year-on-year (YOY) to 4.26M while the number of returned checks amounted to 111,032, exceeding last year's 109,966. In its turn, the car market revealed a 24% YOY slump. As such, the number of new registered cars fell to 13,889 cars in H1 2019. The Association of Lebanese Car Importers attributed the sector's sluggish performance to myriad factors, including the environment of higher interest rates and uncertainty on the political and economic fronts.



Source: Ministry of Tourism; BLOMInvest Bank

Bolstered tourism (14.5% of GDP) partially offset the negative repercussions on economic growth.

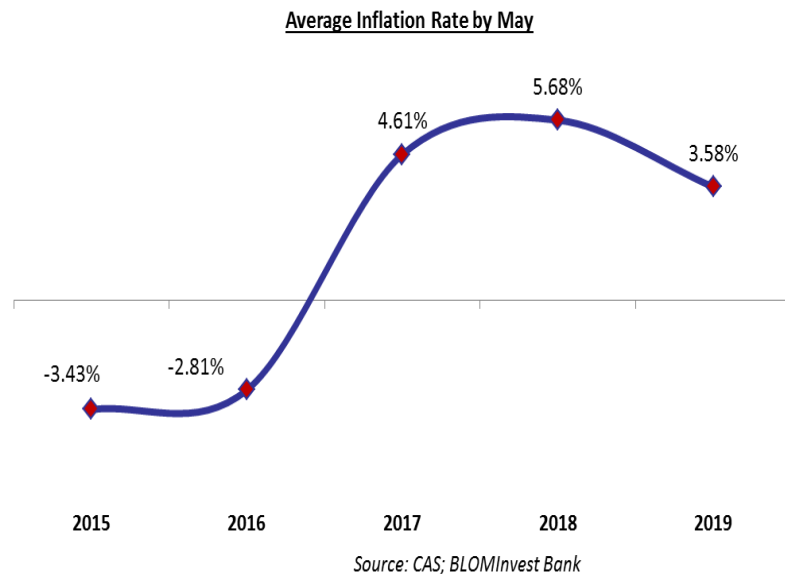
Namely, the total number of passengers climbed by 4.43% YOY to 2.57M travelers by April 2019. The number of tourist arrivals added 5.5% YOY to hit an 8-year high of 692,704 tourists by May 2019, only marginally lagging behind May 2010's tourist arrivals which totaled 732,855 tourists - noting that 2010 was Lebanon's golden year in tourism. The KSA lifting its travel ban since Feb. 2019 helped in boosting the sector, especially on the spending front as Saudis are the largest spenders. Hence, the first 5 months recorded the arrival of 31,069 Saudi tourists, up from 16,874 Saudi nationals in the same period last year. The Occupancy rate in Beirut's 4- and 5-star hotels as per E&Y's latest Benchmark Survey report reached a 4-year high of 67.8% by May 2019, compared to 58.6% during the same period last year. It followed that

annual upticks were recorded in Beirut's average room rate and rooms yield, which climbed from \$174 and \$102 by May 2018 to \$192 and \$130 by May 2019, respectively.

Inflation eased in H1 2019. Lebanon's average consumer prices rose by 3.58% year-on-year (y-o-y) by May 2019 compared to the more pronounced annual uptick of 5.68% recorded in the same period of 2018, according to the Central Administration of Statistics.

The main components that pulled up the CPI are the average prices for "Food and non-alcoholic beverages" (20% of the CPI) and "Education" costs (6.6% of CPI) which registered yearly upticks of 6.21% and 5.17%, respectively, by May 2019.

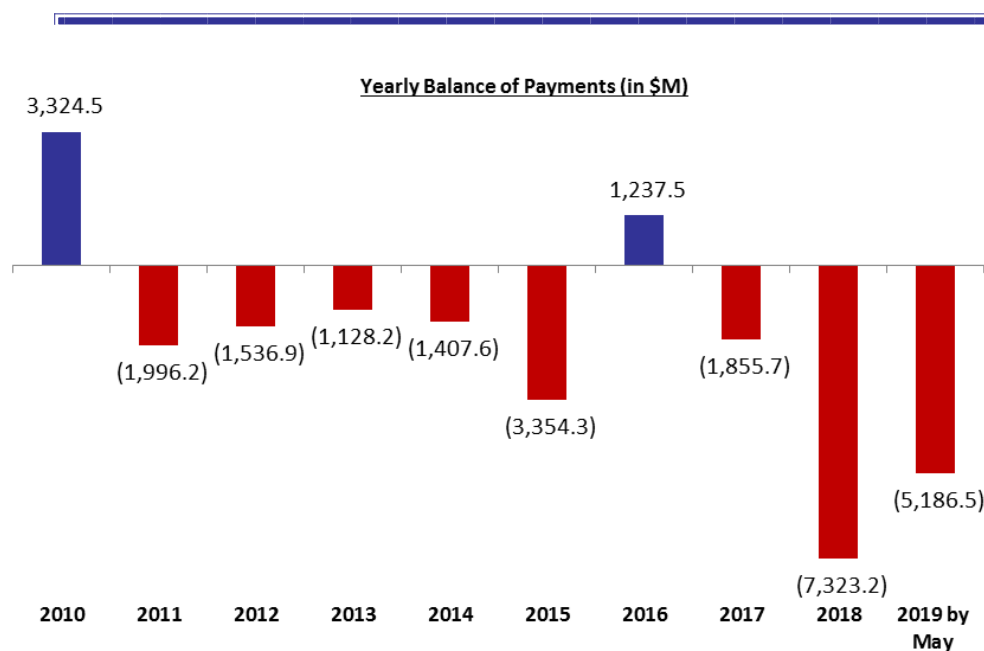
In turn, average prices of "Clothing and Footwear" (5.2% of the CPI) also rose by an annual 14.05% in the first five months of the year.



Balance of Payments

Although the balance of payments is still suffering from the drying of capital inflows and the large deficit in the trade balance, the unlocking of CEDRE funds can change the trend. The BOP registered a deficit of \$5.19B by May 2019, reversing the \$430M surplus recorded by May 2018. Actually, the substantial BOP deficit of \$1.88B registered in May 2019 resulted from prolonged delays to endorse the proposed draft budget by the government. It followed that Commercial banks' Net foreign assets (NFAs) fell by \$508.2M in May 2019, while BDL's NFAs shrank by a monthly \$1.37B, mainly be attributed to \$650M payment of maturing Eurobonds on 20/05/2019. However, the unlocking of CEDRE funds will help break the vicious cycle of BOP deficit and attract capital inflows back into the economy.

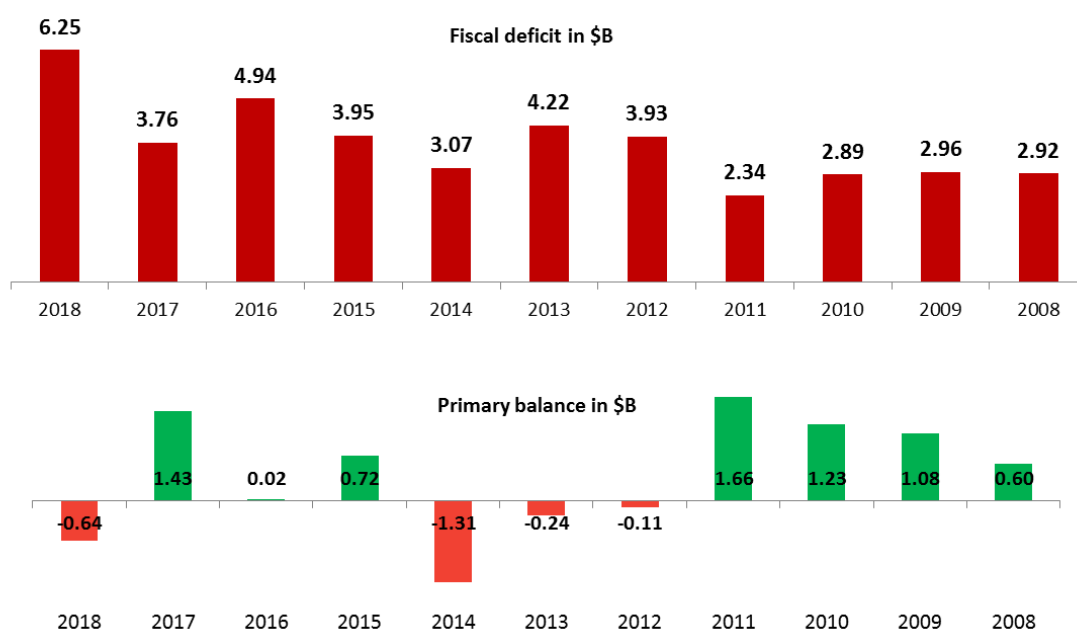
The trade balance continues to reveal a chronic deficit. The most recently available Lebanese customs' data shows the trade deficit widened from \$3.99B in Q1 2018 to \$4.09B in Q1 2019, owing it to an annual 2.9% uptick in total imports to \$4.95B, while total exports added a yearly 5.06% to \$855.8M over the same period.



Source: BDL; BLOMInvest Bank

Fiscal Dynamics

Lebanon's fiscal performance reflected a substantial \$6.3B cash-basis deficit in 2018, but the budget for 2019 is a promising change from last year. The fiscal deficit reached 10.9% of GDP (or \$6.25B) in 2018, compared to a \$3.8B deficit in 2017. The latest deterioration of the country's fiscal dynamics was underpinned by a 15.68% annual growth in public spending to \$17.79B (~29% of GDP) by December 2018, which represented a full materialization of the public salary scale passed by parliament in 2017. Meanwhile, public revenues retreated to \$10.74B or 18.67% of GDP over the same period. As for Lebanon's primary balance, the fiscal balance excluding debt servicing costs, it unveiled a primary deficit of \$635.6M in 2018 (1.11% of GDP) compared to a primary surplus of \$1.43B in 2017.



Source: Ministry of Finance; BLOMInvest Bank

The fiscal deficit in January 2019 showcased an improvement on the previous year, partly due to lower oil prices. The MoF's latest data showed the fiscal deficit narrowed from \$378.91M in January 2018 to \$72.83M in January 2019. Against this backdrop, the primary balance posted a surplus of \$231.74M compared to a deficit of \$106.34M in January 2018. In fact, the smaller fiscal deficit came on the back of a 16.09% yearly decrease in government expenditures to \$1.1B, while fiscal revenues rose by 8.45% YOY to stand at \$1.08B. In detail, EDL transfers in 2018 particularly shot up by 32.26% YOY, owing it to a 30.98% surge in oil prices. However, by Jan. 2019, international oil prices slipped by an annual 12.78% to \$60.24/barrel and thus, EDL transfers were reduced by 26.17% YOY to \$65.85M. Nevertheless, total debt servicing reached \$304.57M in January 2019, up by a yearly 11.74% such that interest payments alone rose by 12.77% y-o-y to \$287.34M.

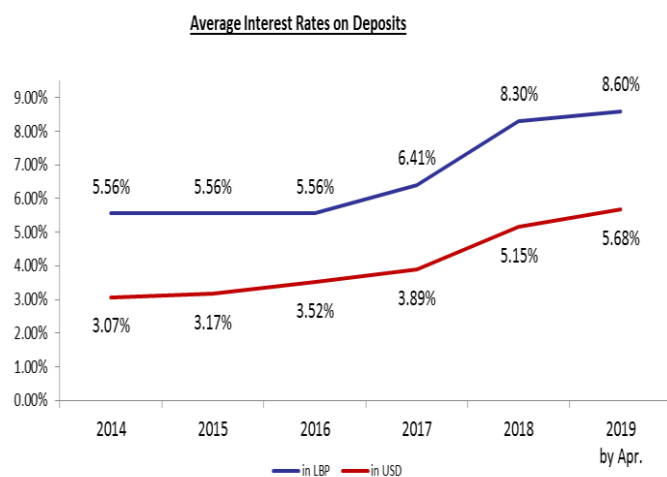
In turn, non-tax revenues pulled up public revenues in the first month of the year while tax revenues slipped. On the revenues front, Non-tax revenues (16.60% of total revenues) increased substantially from 84.92M in January 2018 to \$179.57M in January 2019, largely due to the yearly rise in "telecom revenues" (46.31% of total non-tax revenues) reach \$83.17M in January 2019. Meanwhile, Tax revenues (83.40% of total revenues) declined by an annual 1.13% to \$902.51M in January 2019 such that VAT Revenues (33.84% of total tax receipts) dropped by 16.12% y-o-y to \$305.40M despite the 11% VAT rate effective Jan.2018. The retreat can be linked to the stagnating economy and recession in many sectors, for instance, in the car market, the VAT is paid post-car registration but data from the Association of Lebanese Car Importers revealed a 26.1% YOY decline in the total number of newly registered commercial and passenger cars to 1,948 cars in January 2019. In their turn, "customs' revenues" (11.79% of tax receipts) dropped by 6.49% year-on-year (y-o-y) to \$106.38M.

Monetary Policy

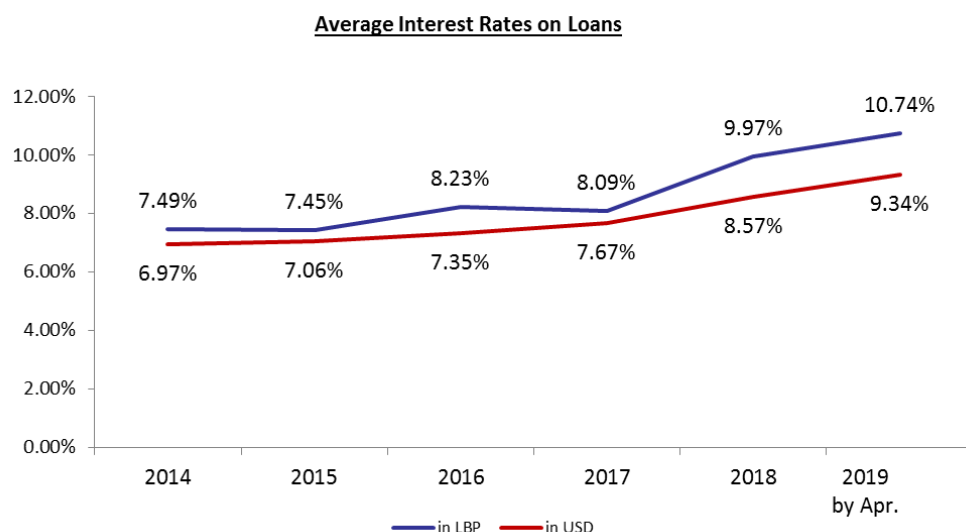
On the monetary policy front, BDL preserved the currency peg. Despite the negative developments on the Balance of Payments front, the foreign exchange reserves level at the central bank (BDL) remains adequate to preserve the peg of the Lebanese pound to the US dollar. BDL has in excess of USD36 billion in foreign assets (excluding gold) at end of June, which constitute a coverage of 22 months of imports of goods, and around 75% of LBP deposits at commercial banks.

Deposits at commercial banks declined in H1 2019 due mainly to one-off factors related to the delay in the formation of a new government, which also led to a delay in the approval of a new budget. The environment of high interest rates persisted through 2019 while commercial banks are still competing to attract deposits, mainly LBP-denominated, since Q3 2018. Total customer deposits (resident and non-residents) lost a 2.06% YTD to stand at \$169.6B by May 2019.

Interest rates climbed further as depicted in the adjacent graph (*Source: BDL; Blominvest*



Bank), to reach highs of 8.6% on LBP and 5.68% on USD by Apr.2019. The upward trend seems to have become the norm.



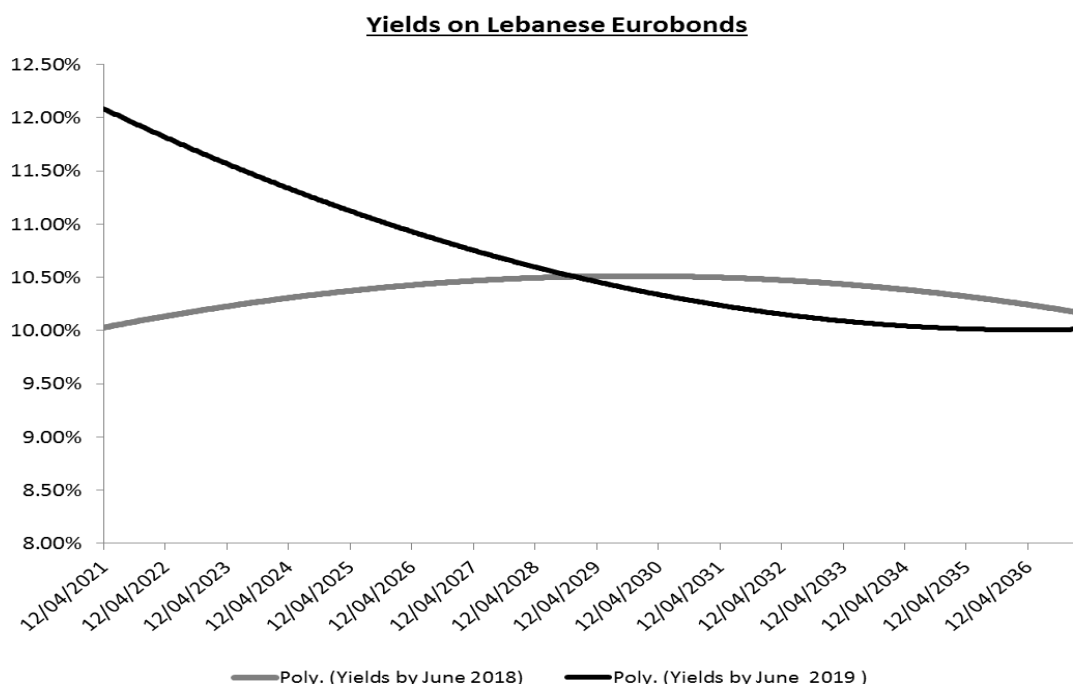
Source: BDL; Blominvest Bank.

In an environment of high interest rates, credit to the private sector is sliding. The lending rates in their turn continued recording upticks, and hit highs of 10.74% on LBP and 9.34% on USD-denominated loans. In fact, loans to resident and non-resident customers slid by 5.13% YTD to \$55.9B by May 2019. Moreover, despite BDL reinitiating the subsidy program in Jan 2019, the amounts made available to accommodate for new housing loans remained very limited.

Eurobonds Market

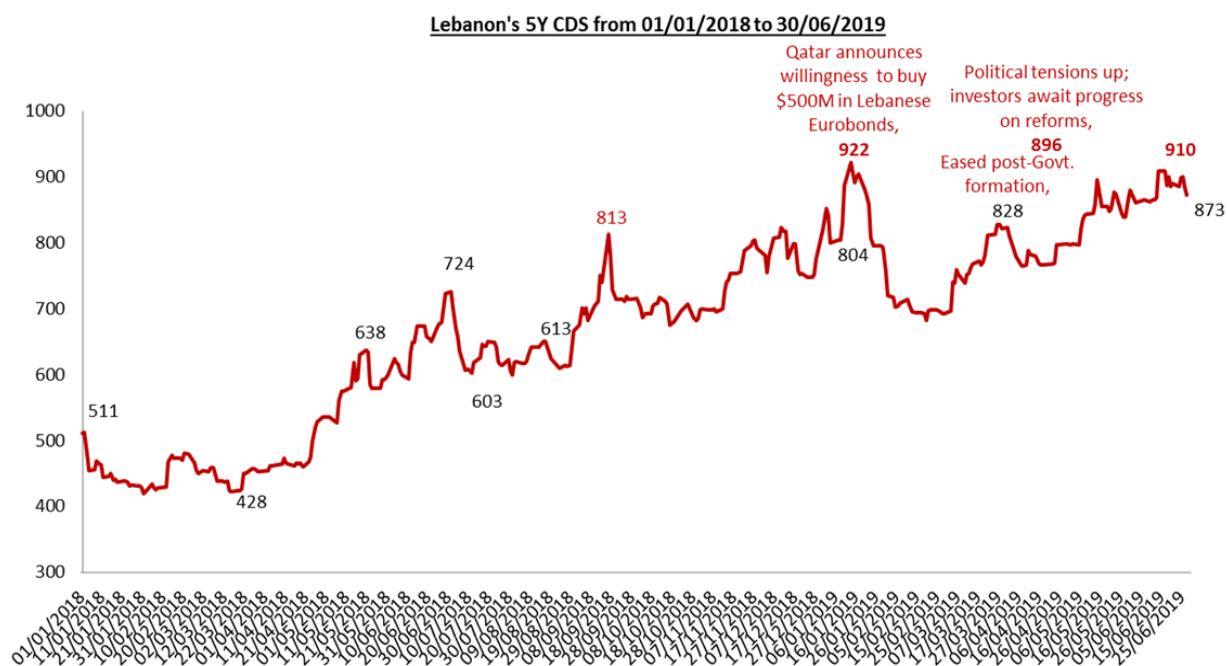
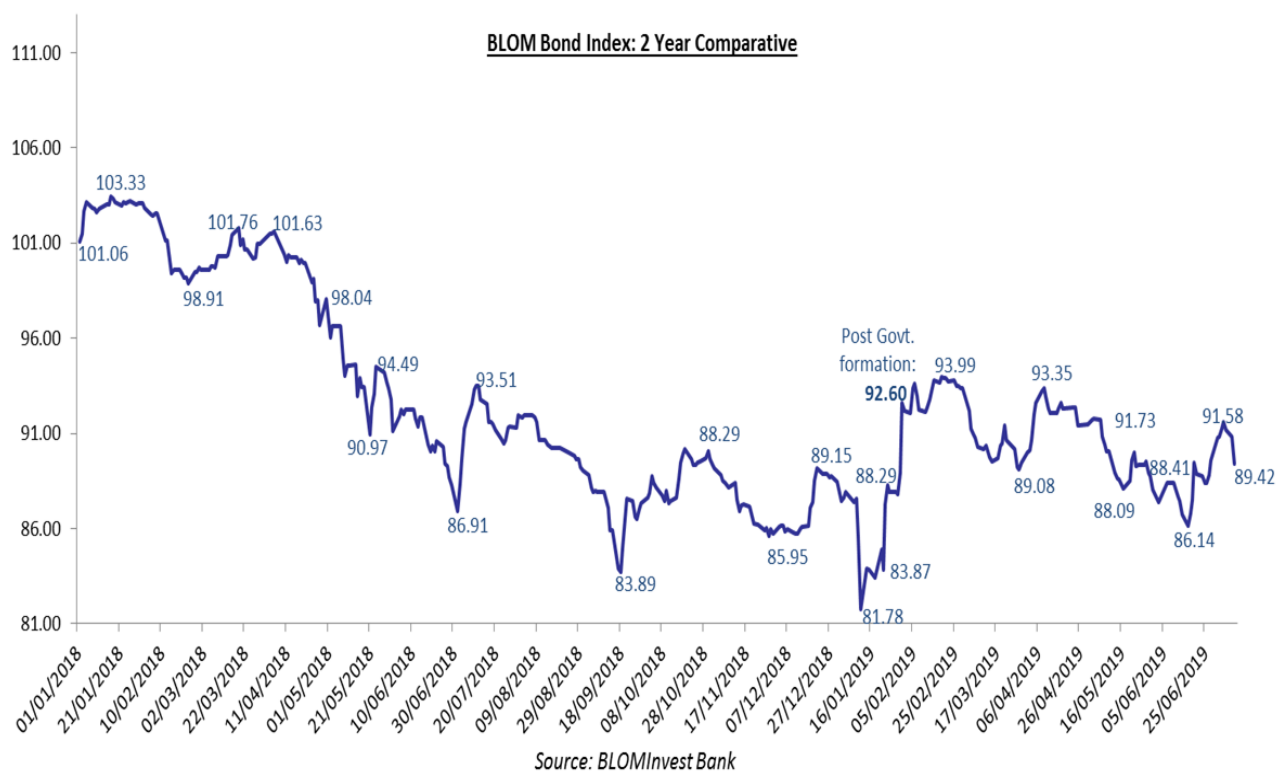
The yield curve remains inverted as the difference in yields on short and long-term bonds squeezed interest margins. Yields on 5Y bonds are still higher than those on 10Y bonds in H1 2019. In fact, the inverted yield curve exhibited in Lebanon's Eurobonds market since Sept. 2018 continued to reflect investors' lack of confidence in the economy, which explains higher demand on long-term bonds that resulted in yields on 5Y bonds exceeding those on the 10Y (as per the graph below).

Accordingly, during H1 2019, the yields on 5Y and 10Y Lebanese Eurobonds climbed to highs of 13.4% and 12.12%, respectively, pre-government formation then eased until mid-June before they hit again highs of 12.42% and 11.65%, respectively, as investors await progress on the reforms. In parallel, the 3M and 10Y yields on US treasuries decreased to reach 2.20% and 2.07%, respectively, over the week ending July 11th, which indicates an inversion of the U.S. Treasury yield curve and thus a squeeze in interest margins for banks relying on maturity mismatch for returns.

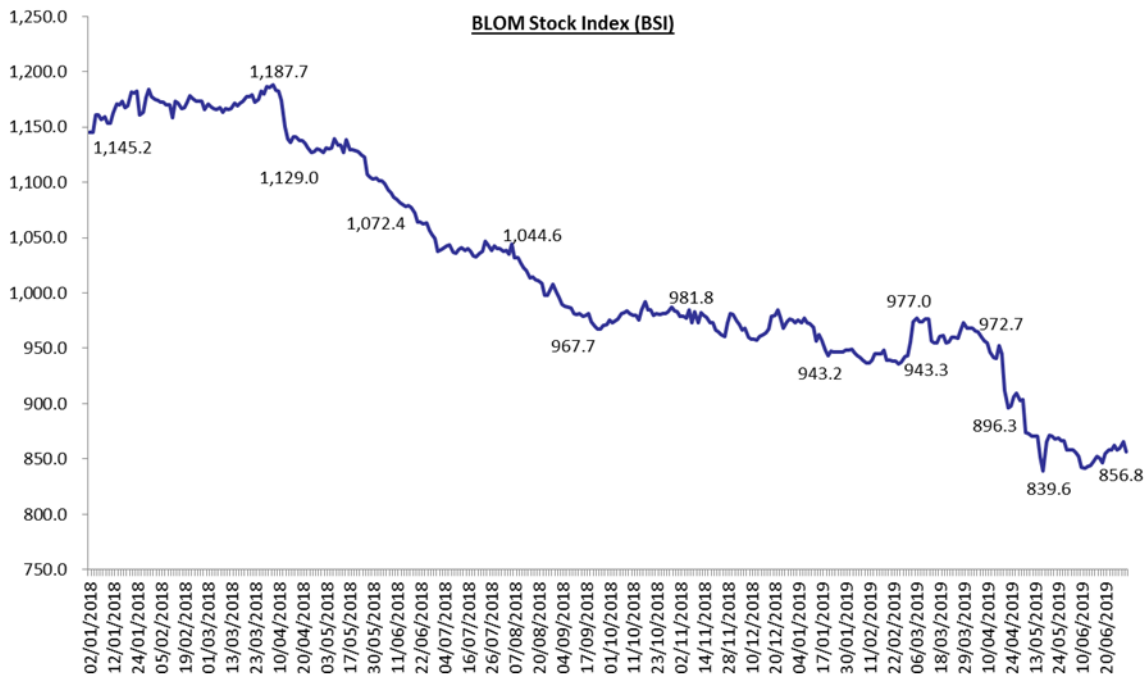


Source: BLOMInvest Bank

Although low, investors' confidence in the country improved in H1 2019 but is set to gain traction once the budget implementation kicks off, especially that JP Morgan recently upgraded Lebanon from market weight to overweight. After 9 months of delay, Lebanon's government was formed on January 31st 2019. Prior to this date, Lebanon's Eurobonds prices witnessed declines, as depicted in the performance of the Blom Bond Index (BBI) below. Since the government formation on 31/01/2019, the BBI grew by 4.55% and the Lebanese 5Y credit default swaps (CDS) slumped from 786 basis points to 699 basis points, also traced in the below figure. It is worthy to note that JP Morgan recently upgrade Lebanon from market weight to overweight, mentioning that *"the spread widening has gone too far against [their] base case that a "credit event should be averted near-term, even as FX deposit flows have shown signs of declining this year, and political impasse remains a hurdle to unlocking the \$11bn of CEDRE funding to the country"*.



Stock Market



Source: BLOMInvest Bank

The BSI's trend scoring below the index's initial capitalization of 1,000 persisted through H1 2019. Starting Sept. 2018, the BSI fell for the first time since Nov. 2005 below the 1,000 mark, and the index reached its lowest of 839.6 points by mid-May 2019, to stabilize at 852.6 points on average in June 2019. The performance of the stock market remained subdued in the first half of 2019 especially as investors adopted a wait-and-see approach albeit awaiting progress on the government's proposed reforms.

Ways Forward

Despite a pending budget approval, the government achieved progress via improving other laws that can help restore Lebanon's governance. The authorities took a recent number of decisions within the framework of fiscal adjustment and this is a step in the right direction. For instance, in the week of July 8th 2019, the government published the new amended, updated version of the *Code of Commerce*. This may directly contribute to mending the business environment and improve the ease of doing business, add to that, the savings promised from freezing public sector hiring for the next 3 years and capping allowances of public sector employees. Such actions are key, as they trigger short-term progress on governance and operating environment fronts whilst the structural reform agenda for more sustainable improvements begin.

Authorities' current target is a deficit to 7.6% of GDP instead of 2018's 10.9%, to lift external competitiveness and regain confidence. This is an ambitious goal that necessitates reforms on the short term and long term. The former may focus on reducing the fiscal deficit and taking measures to increase

public revenues and/or reducing costs by tackling problems like waste management or Electricite Du Liban (EDL).

In fact, EDL's reform plan passed in April 2019 is signaling more optimism on the implementation-front this time. The IMF's concluding statement in 2019 found that *"eliminating electricity subsidies is the most significant potential expenditure saving."* In fact, policy-makers made public promises to improve the provision of electricity in Lebanon that may hold them more accountable. Moreover, in real figures, EDL transfers constitute around 20% of public spending, which can save up to 2.5% to 3% of GDP, i.e. at least saving \$1.5B post-reform. The March 2019 paper released by the Ministry of Energy & Water (MOEW) comes to emphasize and delineate the main, practical steps this reform plan tackles by priority during 2019-2026, in collaboration with the World Bank: substituting fuel oil used by EDL with natural gas (thus reducing production costs by diminishing EDL's reliance on volatile oil prices), boost EDL's generation capacity, and raise tariffs which will *"result in a decrease of the overall electricity bill that citizens are paying because of the anticipated timely decrease of their private generator bills during the same period"*.

On the long-run, the business environment and pro-growth reforms must become a policy priority. This step would entail simplifying administrative procedures, bureaucracy, and the time it takes to open and close a business. In fact, the new code of commerce already out will largely support this priority. Enhancing the ease of doing business in Lebanon can give back the country the position of being a capital hub. In addition, a government with good governance on all policy fronts is of utmost importance as transparency spurs accountability, credibility, and confidence.

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