Overview of the Lebanese Economy in 2019

BLOMINVEST BANK

March 13th 2020

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MACROECONOMIC OVERVIEW

Lebanon was in a state of "economic recession" in 2019. GDP growth dipped into negative territory in the consecutive quarters Q1 and Q2 of 2019. During the period, a political deadlock prolonged parliamentary negotiations which extended over 8 months, before the formation a new cabinet was announced on Jan. 31st 2019 (following the elections of May 2018). Nonetheless, progress on reforms for the pledged CEDRE funds was delayed. By October 17th 2019 civic protests erupted across Lebanon, catalyzing a full-fledged financial and economic crisis. Notably, Q4 recorded a substantial slump in GDP such that the growth rate ranged between -5% to -6%. Consequently, Lebanon's annual growth stood at -2% in 2019. It followed that the average monthly inflation rate more than quadrupled between October and December 2019, as it climbed from 1.33% to 6.96% in December. The steep inflation uptrend resulted from the imposition of capital controls for the first time in Lebanon in November. The restrictions led to the emergence of a parallel market with the USD/LBP surpassing the 2,000 mark while the official rate remained at 1,507.5. As a result, essential raw materials and end products became very expensive vis-a-vis citizens and businesses, eroding purchasing power .

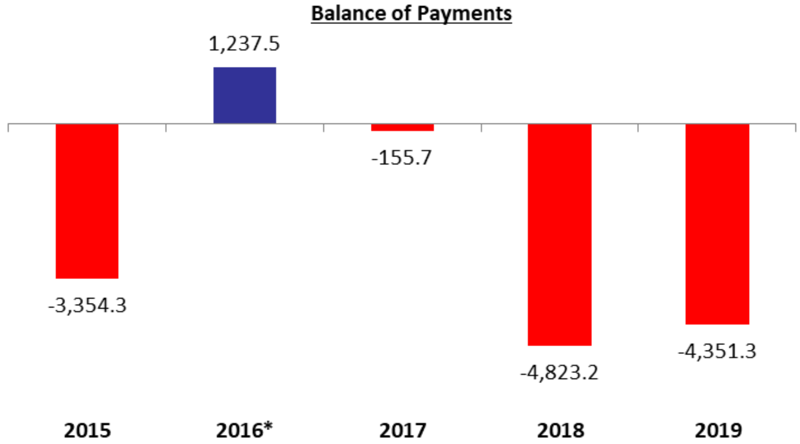
National protests and sovereign downgrades in Q4 unveiled recessionary facets in the Lebanese economy. The civic protest's economic repercussions fully materialized in November when the PMI slumped to an all-time low of 37 points. Companies began laying-off employees, fueling unemployment. In turn, Moody's credit agency downgraded Lebanon's issuer credit ratings to "Caa2" from Caa1, while S&P lowered long-term credit ratings on Audi Bank, Bank Med, and BLOM Bank from "B-" to "CCC". Nevertheless, Banque du Liban's (BDL) issued December 04th Circular -instructing banks to pay the interest on foreign deposits 50% in Lebanese pounds and 50% in US dollars- which triggered further downgrades by 3 rating agencies. By end 2019, Moody's yet again downgraded the Standalone Baseline Credit of Bank Audi, BLOM bank and Byblos bank from Caa2 to "Ca". In addition, S&P lowered Lebanon's foreign and local-currency Issuer Credit ratings to "Selective Default" on 3 Lebanese Banks (Audi, BLOM, Bank Med), while Fitch downgraded Lebanon's long-term foreign currency Issuer Default Rating (IDR) from CCC to "CC."

Lebanon's fiscal deficit narrowed, yet gross public debt continued growing on an unsustainable trajectory. The (cash-basis) fiscal deficit decreased from $4.73B by October 2018 to $4.02B by October 2019. The breakdown provided by the Ministry of Finance (inclusive of treasuries) revealed an 8.57%YOY down tick in total government spending, which outweighed the 5.49% annual downtick in public revenues totaling $13.4B and $9.38B, respectively. On the counterpart, Lebanon's gross public debt hit $91.64B in 2019, as it recorded a large annual increase of 7.6% and debt servicing costs stood at $4.24B. In details, Lebanon's total debt in "Eurobonds" amounted $31.31B in 2019, with BDL holding $5.7B of Eurobonds, while total outstanding Lebanese Treasury Bills totaled $56.85B in 2019 .

Moreover, the car market slumped remarkably while real estate activity picked up as capital controls remained in place end-2019. "The number of new cars registered [in] November 2019 dramatically dropped by 79% [compared to] November 2018" (Association of Cars Importers, AIA). By December 2019, total new cars registered fell by 34%YOY to 23,289. AIA attributed the dramatic drop to imposed capital controls, suspended car loans and documentary credits for imports, high interest rates, and dollar illiquidity. On the counter part, the real estate sector presented "safe" investments for big depositors seeking risk-diversification post-October 17th amid talks of debt restructuring and a potential sovereign default. As such, the number of RE transactions in December alone stood at 6,189 transactions, almost twice November's. Yet, the cumulative number and value of transactions contracted by 17.07% and 15.92%YOY, to 50,352 transactions worth $6.8B in 2019. Demand on new projects remained subdued with total number of construction permits and construction area authorized slumping by 19.8% and 32.7%YOY respectively, to 11,074 permits covering 6.1Msqm in 2019 .

Tourism in H1 was a bright spot in the economy, but Q4 developments hampered the sector's activity. In H1, Lebanon welcomed 923,820 tourists, similar to 2010 levels, and the KSA lifted its 2017 travel ban. Nonetheless, the number of airport passengers declined by 1.72%YOY, totaling 8.69M passengers by end-2019, and thereby marking its first slump in 8 years. The cumulative number of tourists followed suit, falling by 1.4%YOY to 1.94M tourists over the same period .

On the external front, foreign currency outflows significantly exceeded inflows. Lebanon's trade deficit narrowed by 8.9%YOY to $15.50B as the value of imports decreased by 3.7%YOY to $19.2B, while exports' value added 26.6% to $3.7B in 2019. Starting December 2019, BDL committed to cover imports of essential goods (medicines, fuel, wheat) due to the shortage in dollars. More prominently, the balance of payments (BOP) recorded a deficit of $4.35B in 2019, down from 2018's $4.82B deficit. BDL's Net Foreign Assets (NFA) dropped by $2.4B (partly related to importing essential goods) while NFAs of commercial banks fell by $1.95B in 2019 (related to the outflow of deposits).



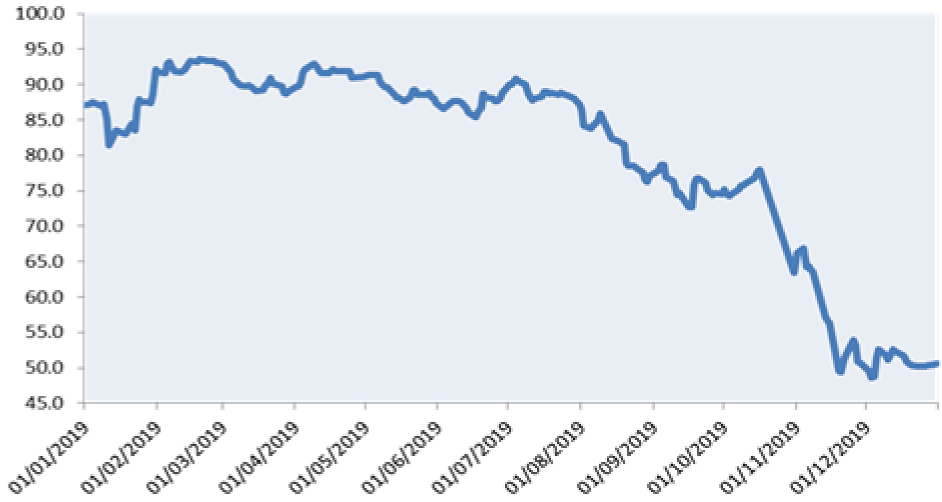
Source: BlomInvest Bank; BDL
* Surplus on the back of BDL's June 2016 financial engineering.

In fact, money supply M1 grew substantially while M3 shrank. With capital controls in, M1 inclusive of currency in circulation and demand deposits in LBP grew exponentially by an annual 42.8% to $16.6B by December 2019 compared to a 12% uptick last year. This is mainly attributed to people's preferences shifting to cash, given the limits on bank cards and the loss of confidence in the banking sector amid the heightened uncertainty. By the same token, M3 fell by 4.5%YOY to $202.5B end-2019 driven by drops in USD deposits and more so in LBP deposits as a result of the flight to safety and transfers abroad.

In turn, the Beirut Reference Rate (BRR) rose. The BRR, stood at 8.2% on USD and 11.5% on LBP in December 2018 and climbed to 10.39% on USD and 13.49% on LBP in Dec. 2019 .

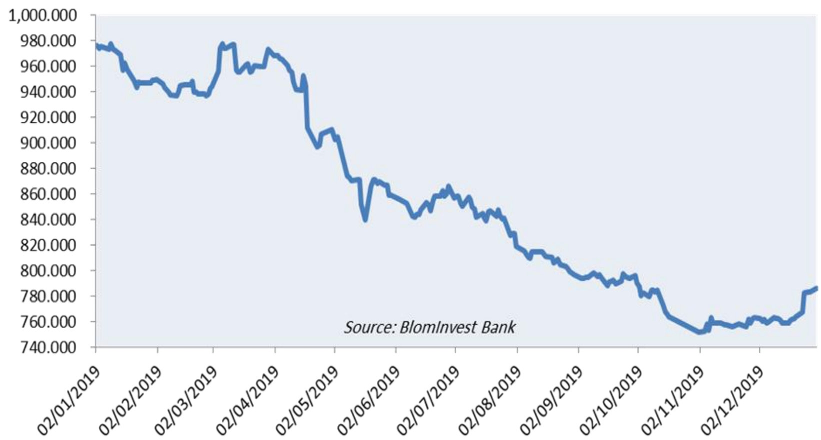
Confidence in the Lebanese government was eroded. The economic recession was evident as the performance of Lebanese Eurobonds and the stock market collapsed. Social rioting and political bickering during parliament sessions following the resignation of PM Hariri's government end-October 2019 sent the Blom Bond Index (BBI) to an unprecedented historical low of 48.59 points by December 03rd, hand-in-hand with an all-time high 5Y Lebanon CDS at 2,637 basis points (bps) as per Markit. The BBI closed the year at 50.5 points with 5Y CDS at 2,417 bps in 2019, noting that BDL had settled $1.5B in maturing Eurobonds on Nov. 28th. Also, the yields on 5Y and 10Y Eurobonds surged to unprecedented highs of 39.2% and 21.6%, respectively, on Dec. 04th. By end-2019, they stood at 37.5% and 21.9%, compared to last year's 10.8% and 10.7%, respectively. In its turn, the Blom Stock Index, which measures the activity on the Beirut Stock Exchange, fell by an annual 19.6% to end 2019 at 785.56 points, after hitting an all-time low of 751.3 points beginning November when banks opened their doors after 15 days of shutdown following the protests.

BLOM BOND INDEX



Source: BLOMInvest Bank

BLOM STOCK INDEX



Source: BLOMInvest Bank

THE LEBANESE BANKING SECTOR IN FOCUS

As a result of October's uprising, several banking and financial measures had to be taken. First, due to the severity of the shock (material Clause), major listed banks have opted with the approval of BDL to postpone publishing financial results post H1 2019. Second, to protect their liquidity especially in USD, banks had to resort to putting limits on withdrawals and international transfers. Third, to shore up bank capital, BDL issued a directive to banks not to distribute profits in 2019 and to increase their capital by 20% by June 2020. Fourth, to reduce financing costs for banks, BDL also directed banks in

December to set limits on interest rates on deposits at a maximum of 8.5% for deposits in LBP and at 5% for deposits in USD.

As to commercial banks, their balance sheet witnessed a decline in assets by 13.1% in relation to 2018 to reach $216.8B by end 2019. However, starting December 2019 (and according to the offsetting criteria in IAS 32 "Financial Instruments: Presentation"), banks have offset their loans taken from BDL in LBP with their corresponding placements at BDL in LBP carrying the same maturities, which led to the erasing of assets close to 37.5B in equivalent USD.

In terms of loans to the private sector, those declined to $49.8B, falling by a notable 16.2%. Part of this decline in loans, though, was due mostly to real estate developers paying back their loans from the brisk sales of properties to people preferring to exchange their frozen deposits to fixed assets. In addition, it is ascertained that NPLs for the sector must have doubled to more than 10% at end 2019 because of the economic crisis, but that figure needs to take into account the reduction in loans that tends to inflate the Non-Performing Loans (NPLs) ratio.

In relation to private customers' deposits, they fell by 8.8% to settle at $158.9B. The highest monthly drop in total private deposits was recorded during November (3.43%) where the USD and LBP deposits decreased by 1.78% and 7.98% to reach $121.44B and $41.16B, respectively. Resident customers' deposits (78.70% of total private deposits) reached $112.51B in December 2019, decreasing by 7.7%. In details, the major drop was recorded in LBP deposits by 25.82% to reach $34.47B while USD deposits witnessed an uptick of 1.77% reaching $90.55B. Non-resident customer deposits (20.43% of total private deposits) reached $32.45B at end 2019, declining yearly by 13.98%. In this category, both deposits in LBP and foreign currency retreated by 27.19% and 12.27% to reach $3.14 and 29.31B, respectively. And, as expected, the dollarization rate for total private deposits increased from about 70% to 75.6% at end 2019.

As to shareholders' equity, it increased slightly from $20.1B to $20.7B, perhaps an early indication that the sector had hardly made any profits in 2019, especially in light of BDL's directive not to distribute the profits of that year .

Lastly, banks held in 2018 $17.4B of debt in LBP and $16.1B in USD, which constituted respectively 33.6% of total debt in LBP and 47.9% of total debt in USD. Whereas in 2019 their exposure to sovereign debt was reduced, as banks' holdings of LPB debt fell to $14.6B and of USD debt decreased to $13.8B, constituting 25.2% and 40.9% of the total. In terms of aggregate figures, banks held 39.1% of aggregate debt of $85.2B in 2018, but only 31% of the aggregate of $91.7B in 2019.

As to BDL – the other main component of the banking system - the assets side of its balance sheet reveals that assets increased by 0.6% to $141.4B at end 2019, noting that starting 15/03/2019 (and according to the offsetting criteria in IAS 32 "Financial Instruments: Presentation") BDL has offset loans with their corresponding deposits in LBP originated simultaneously with banks and carrying the same maturities in the amount of $21.4B. Of these assets, Gold valuation increased by 22% to $13.9B due to higher gold prices; securities portfolio rose by 20.2% to $45.7B (of which $5.7B in Lebanese Eurobonds) and driven by holdings of more LBP TBs; and foreign currencies dropped by 9.1% $29.6B as a result of financing for essential imports. Of course, because of the crisis, BDL has relinquished supporting the exchange rate peg in October 2019 except for transactions in the banking sector and for essential commodities.

Regarding the liabilities side of the balance sheet, currency in circulation witnessed an increase by 80.2% to $7B at end 2019, driven by people's preference for the safety of cash starting in late October onwards; banks' deposits fell 8% to $107.6B, affected nominally by the offsetting adjustment mentioned above; and public deposits increased by 7.9% to $5.4B, perhaps due to lower discretionary spending in late 2019 because of the uprising and because of more TBs financing by BDL.

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