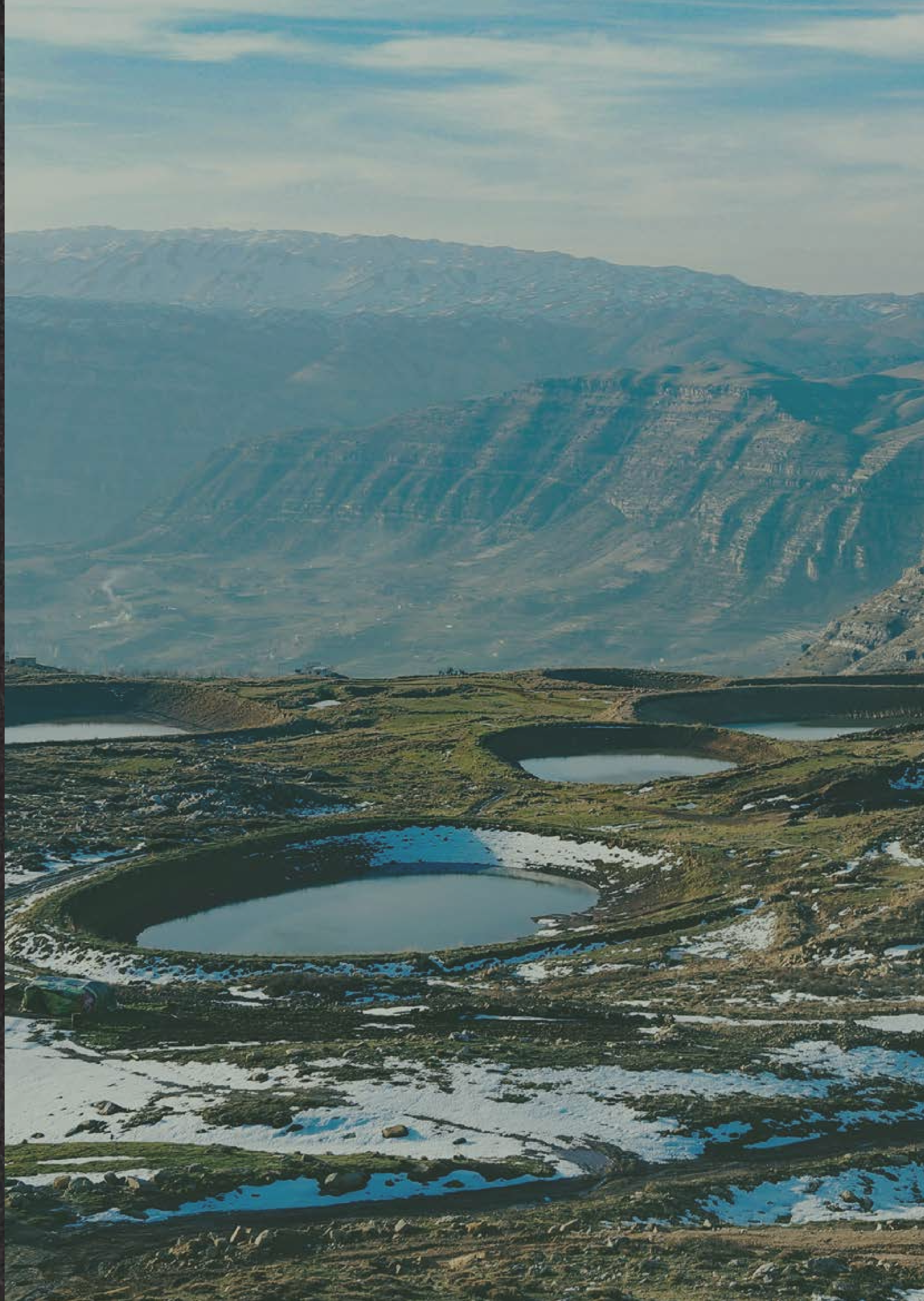
PART I

GENERAL ECONOMIC DEVELOPMENTS

01



I- WORLD ECONOMY

1-1

Based on the latest information provided by the IMF- World Economic Outlook, April 2018, the world real GDP growth rate increased to 3.8% in 2017 compared to 3.2% in 2016, with the recovery of the international commercial and investment activity and in the wake of supporting conditions and fiscal policies. It is expected for the economic recovery that started gradually from the middle of 2016 to gain more momentum in 2018 and 2019 so that economic growth rate increases to 3.9% for the two years with the expectations of the continuation of the accommodating fiscal conditions, and the occurrence of a large financial expansion in the USA accompanying the positive impacts of tax reforms in it, especially on the inflow of capital, income and investment.

1-2

The expectations for 2017 were tied to the increase in the growth rates of the US economy as well as the economy of the Eurozone to 2.3% for the given year (from 1.5% and 1.8% respectively in the previous year) backed by the accommodating fiscal and monetary policies and the improvement in the growth rate of each of the Chinese and Japanese economies to 6.9% and 1.7% respectively (compared to 6.7% and 0.9% respectively in 2016). Expectations also show an additional improvement in the growth of the US economy reaching 2.9% in 2018 and 2.7% in 2019 for the reasons mentioned above and related to the expansionary fiscal policy, given that monetary policy is predicted to be more tightened with the expectations that the Federal Reserve will increase the base interest rate to 2.1% in 2018 and 2.9% in 2019. The growth rate in the Eurozone will slightly increase to 2.4% before declining to 2.0% for the periods mentioned respectively. Concerning the Chinese economy, expectations point to a decline in growth to 6.6% in 2018 and 6.4% in 2019 with the contraction of credit growth and fiscal incentives. Japan will also witness a decline in economic growth rate to 1.2% and 0.9% respectively.

1-3

There could also be negative repercussions on growth in the later period of 2019 and maybe before that as a result of many factors most importantly the possibility of a fast and severe tightening in public finances with the closure of the output gap, and the speed of the exit from the period of non-conventional monetary policy, or a return to the conventional monetary policy and tightening it with the increase in the inflation in wages and prices, and the escalation in the severity and scope of commercial restrictions and the retaliatory measures and enhancing protectionist policies and the activation of the geopolitical tensions.

WORLD ECONOMIC OUTPUT GROWTH RATE (REAL GDP) IN 2016 AND 2017, ESTIMATED & EXPECTED FOR 2018 AND 2019

	Realized		Expected	
	2016	2017	2018	2019
World economy	**3.2**	**3.8**	**3.9**	**3.9**
Developed countries, o/w:	**1.7**	**2.3**	**2.5**	**2.2**
The US	1.5	2.3	2.9	2.7
The Euro area	1.8	2.3	2.4	2.0
Japan	0.9	1.7	1.2	0.9
Canada	1.4	3.0	2.1	2.0
United Kingdom	1.9	1.8	1.6	1.5
Emerging and developing countries, o/w:	**4.4**	**4.8**	**4.9**	**5.1**
Africa	1.4	2.8	3.4	3.7
East and Central Europe	3.2	5.8	4.3	3.7
Commonwealth of independent states CIS, including Russia	0.4	2.1	2.2	2.1
Russia	-0.2	1.5	1.7	1.5
Brazil	-3.5	1.0	2.3	2.5
Developing Asian countries, o/w:	**6.5**	**6.5**	**6.5**	**6.6**
China	6.7	6.9	6.6	6.4
India	7.1	6.7	7.4	7.8
Middle East and North Africa	4.9	2.2	3.2	3.6
Central and South America and the Caribbean	**-0.6**	**1.3**	**2.0**	**2.8**

Source: WEO report / IMF

The Middle-East and North Africa (MENA) Region

1-4

The economic growth rate in the MENA region decreased to 2.2% in 2017 compared to 4.9% in the previous year due to the effect of the OPEC latest oil production cuts. However, it is expected that the speed of economic activity will fasten in 2018 (+3.2%) and 2019 (+3.6%) with the end of the above mentioned OPEC agreement to reduce oil output and the recovery of oil production, even if this activity remains low over the medium term in comparison with the average for the period 2000-2014 where the economic growth rate reached 4.8%. The inflation rate increased to 6.6% in 2017 compared to 4.9% in the previous year, and it is predicted to increase to 8.7% and 7.1% in 2018 and 2019 respectively with the expectation of the increase in oil prices after the end of the OPEC agreement period, the withdrawal of the United States from the nuclear agreement with Iran and the raise in global interest rates.

1-5

The results and directions differed among oil-exporting and oil-importing countries. Concerning the first group, the slowdown in economic activity was deeper in the GCC countries which was offset by better results in countries non- GCC members. The economic growth rate declined to -0.2% in GCC countries in 2017 compared to 2.1% in 2016 affected to a great extent by the decline in oil production due to the OPEC agreement, which exceeded the impact of the continuation of the recovery of the non-oil growth in most concerned countries. GCC countries continued the attempts at fiscal consolidation. Efforts conducted in this framework include the start of the implementation of value-added tax in Saudi Arabia and the United Arab Emirates in January 2018 and the expectation of applying it in other countries of the GCC in the same year. Concerning public spending, the public investment efficiency indicators show that the performance of oil-exporting countries is on average better than emerging markets performance with a large gap remaining with advanced economies. Expectations show that economic growth rate will increase again in GCC countries to 1.9% in 2018, and then to 2.6% in 2019 with the end of the OPEC agreement and reform measures implemented by these countries.

1-6

Concerning **oil-importing countries,** the growth rate remained heavily influenced by the burdens of the ongoing struggles and their ramifications on the region, the security fears, the weak public investment and the delay in implementing or continuing the structural reforms. Growth outlooks differed between one country and the other in this group which recorded a growth approaching 3.7% in 2017 that is improved in comparison to 3.3% in 2016 as a result of the increase in confidence in some countries and thus an increase in foreign investment in them. It is expected that the rate of growth will reach 4.3% in 2018 and 4.6% in 2019 with the beginning of the implementation of reforms especially in the labor market to reinforce productivity, create job opportunities in addition to improving the business environment.

REAL GROWTH RATE IN 2016 AND 2017, & EXPECTED FOR 2018 AND 2019

	Realized		Expected	
	2016	2017	2018	2019
Middle East & North Africa	4.9	2.2	3.2	3.6
GCC countries	2.1	-0.2	1.9	2.6
Oil Importing countries	3.3	3.7	4.3	4.6

Source: WEO report / IMF

II- THE LEBANESE ECONOMY

2-1

In 2017, the Lebanese economy suffered and for the seventh year in a row from a weak growth for structural considerations that aggravated with the continuation of the fallbacks of the Syrian crisis and the regional and international struggle. The BDL had estimated the growth rate for the given year to be in the region of 2.5% whereas the estimations and expectations of the IMF pointed-out to a growth rate in the region of 1.2%. These figures remain less than the world growth average of 3.8% and the average growth rate registered by the MENA countries approaching 2.2% if we were to adopt the IMF predictions. In any event, this growth rate remains insufficient in providing new job opportunities at the desired pace and reinforcing economic well-being. Despite the fact that Lebanon has achieved many accomplishments especially at the end of 2017, with the passage of the law of public private partnership (PPP) and the launching of the operations of exploration and granting concessions of oil, and the passage of the first general budget for more than 12 years in October 2017, in addition to passing the electoral law, which are all good steps that build the foundations of organizing the work of the institutions and aiming to enlarge and activate the economy, a new political crisis emerged in November reflected in a temporary resignation of the Prime Minister to bring with it negative repercussions on the economy and the monetary conditions that quickly dissipated with the return from the resignation.

2-2

And as it is predicted for the economic performance to remain weak in 2018 even if it improves slightly from 2017, with the achievement of the parliamentary elections and the budget law of 2018 and the success of the CEDRE conference in Paris and other advantages, It is hoped for the next period to be promising with the new government beginning its spending on infrastructure and performing the structural reforms that are necessary for the investment program in the sectors of transportation, communication, water, electricity and others for the purpose of improving economic activity and removing it out of the slow state witnessed in the previous year. The IMF expected in its report on World Economic Outlook of April 2018 (before taking into account the possible positive implications of the CEDRE conference) for Lebanon to achieve real economic growth of 1.5% and 1.8% in 2018 and 2019 respectively.

GDP, CURRENT ACCOUNT, GROWTH & INFLATION RATES

	2015	2016	2017
Real Growth rate (%)	0.2	1.7	1.2
Change of the average consumer price Index (%)	-3.75	-0.82	4.48
GDP Deflator (%)	2.6	1.4	2.5
GDP (LBP billion)	75,240	77,612	80,507
GDP (USD billion)	49.9	51.5	53.4

Sources: Central Administration of Statistics (CAS) – IMF for real growth rate and GDP deflator in year 2017.

CEDRE conference: Partnership between Lebanon and the international community for stability and growth achievement

The CEDRE conference was held on 6 April 2018 in Paris through an initiative by the French President and with the participation of more than 48 countries and international organizations and a group representing the private sector and civil society. This step was considered a new start for Lebanon after establishing a revived partnership with the international community under the heading of protecting the stability of Lebanon, boosting its growth, and creating job opportunities in it. It also created an opportunity to modernize the economy, restore the rehabilitation of infrastructure and launch the abilities of the private sector and its partnership with the public sector. The vision of the Lebanese government presented to the conference for stability, growth, and job creation relied on four interrelated pillars: Increasing investment in infrastructure through the program of investment expenditure, achieving it through enforcing tax revenues in order to reduce the budget deficits to GDP ratio by 5 percentage points in the next five years, achieving structural reforms including fighting corruption, improving collection and tax administration, rationalizing customs in addition to the necessary sectorial reforms to make sectors more competent and sustainable.

Lebanon received from this conference that supports economic stability pledges and commitments approaching USD 11 billion between grants and soft loans with interest rates not exceeding 1.5%, and for a grace period reaching 10 years and maturities approaching 25 years. With it appeared domestic preparations to place for execution the reform plans and the developmental projects for the next twelve years. It is hoped for issues to develop as planned and at the promised pace or by spending around USD 1.5 billion a year in the first stage on infrastructure projects with priority.

2-3

In 2017, the key economic indicators revealed that economic growth remained for the seventh year in a row, at a weak level corroborating the growth predictions mentioned above as most of these indicators registered either a slight increase or a decline whereas the improvement was quasi concentrated in the indicators related to the tourist activity and passengers via the airport. What follows are the most important features of the previous year:

- An improvement in the BDL coincident indicator by 5.8% in 2017 compared to 3.8% in 2016.

- The real estate sector witnessed an improvement on the demand side whose indicators took a positive trend as the real estate sales operations and transactions registered an increase of 14.5% and 15.3% respectively in 2017 compared to the previous year. As a result, the total real estate sales value increased by 17.5%. The value of real estate fees witnessed the same trend by registering an increase approaching 18.1% in comparison to 2016. In comparison, real-estate supply took the opposite direction as the construction area permits declined by 4.1% reflecting the current and future construction activity, in addition to the cement delivery that decreased in its turn by 1.9% compared to the previous year, knowing that it represents a secondary indicator to the existing construction activity.

- The touristic sector was featured positively as the number of incoming passengers via the airport increased by 8.6% compared to the registered number in the previous year due to the increase in the number of tourists arriving to Lebanon by close to 10%, mostly from the European countries whereas the number of tourists from the Arab countries approached one third. The outgoing passenger activity increased by 8% compared to 2016. The tourist activity affected the hospitality sector as hotel occupancy rates in Beirut reached 63.7% in 2017 compared to 59.5% in 2016 in comparison to an average of 62.2% in 14 Arab markets included in a study prepared by Ernest and Young.

- The maritime transportation indicators registered a disparity in performance between the decline in the number of ships and the size of the delivered commodities, and the increase in the size of shipped products and the number of emptied containers. Whereas the value of cleared checks reflected a weak growth or even a stability in the consumption and investment expenditure in 2017 compared with 2016.

- A disparity in the performance of the agricultural sector as the quantity and value of agricultural imports increased by 10.8% and 9.2% respectively in 2017 whereas the size and value of agricultural exports decreased by approximately 5.6% and 3% respectively as a result of the paralysis in land commerce through the Syrian-Jordanian border. For the industrial sector, it is always affected by the increase in the transportation cost of Lebanese commodities as well as the increase in shipping and insurance costs due to the war in Syria which pressures demand causing the weakening of the competitive edge of these commodities.

- We mention in this domain also to a substantial decrease in the number and amounts of KAFALAT loans granted to small and medium enterprises especially those operating in the agricultural and touristic sectors respectively by 24% and 28%.

2-4
The performance of **public finances** in 2017 was positive compared to the previous year as the public sector deficit declined from LBP 7,453 billion to LBP 5,662 billion, thus making its level as a percent of GDP decrease from 9.6% in 2016 to 7.0% in 2017 due to the exceptional increase in revenues (LBP +2,565 billion) resulting from the collection of the tax on bank profits caused by the financial engineering operations implemented with the BDL in 2016, on one hand, and the decline in the trend of expenditure growth also (LBP -774 billion) with the decrease in the size of transfers to the municipalities on the other hand, allowing the achievement of a large primary surplus in 2017 amounting to LBP 2,152 billion in comparison to a much lower surplus reaching LBP 31 billion only in 2016. Whereas the performance of public finances regarding the size of government expenditure or the public consumption and investment was not helpful in incentivizing economic growth as primary expenditure outside debt service increased by around 3% only.

2-5
Regarding **monetary policy,** the BDL continued in 2017 to support economic activity and incentivize growth through the existing incentive packages, which aimed in a principal manner to help productive sectors and the housing sector through reducing the cost of credit on the borrower affected by the structure of high interest rates restraining economic growth. This support is part of a new mechanism initiated in 2018. The BDL continued to reinforce its foreign currency reserves (excluding gold estimated at USD 12 billion at current prices) that exceeded USD 43 billion at the end of 2017, to protect monetary stability and withstand any sudden pressure such as the ones that emerged upon the resignation of the Prime Minister in November 2017.

2-6
The **Banking sector,** beyond any doubt, had a primary contribution in the success of the initiatives and efforts of the monetary authority, and in incentivizing economic activity through the subsidized and other loans provided to the resident private sector which increased by 6.1% or by approximately the same figure registered in the previous year. The financing of both the public and private sectors became greater than 175% of GDP.

2-7
The contribution of the **external sector** to economic activity and growth was weak or even negative with the decline in the net value of exports of goods and services (exports minus imports), according to the primary available statistics, as the deficit in the current account increased from USD 16.1 billion in 2016 to around USD 16.7 billion in 2017, while the service balance remained positive though it has decreased from USD 1.9 billion to USD 1.8 billion over the two mentioned periods respectively. It is to mention that net capital inflows decreased in 2017 compared to the previous year as the change in net foreign assets in the financial system recorded a deficit amounting to USD 156 million in 2017 compared to a surplus of USD 1.2 billion in 2016 in light of the financial engineering operations of the BDL.

2-8
The largest international credit rating agencies such as Moody's, Standard & Poor's and Fitch agree in their credit assessment of the sovereign rating of the Lebanese government that the largest areas of strength that Lebanon enjoys lie in a solid bank deposit base, a high level of reserves, the timely meeting of the Lebanese government of its financial obligations despite the difficulties it faces, and a relatively high average per capita income. Whereas the challenges they agree on are summed-up in a high level of public debt, high budget and current account deficits, and the continuation of the regional struggles. In parallel, the future vision reflects the possibilities of speeding-up the pace of implementing the reforms in Lebanon, reinforcing the work of constitutional institutions, the preservation of high levels of foreign currency reserves, and the continuation of deposit flows to the financial sector by an amount sufficient enough to finance both the public and private sectors.

2.9
According to the IMF, the economic growth outlook for Lebanon in the medium and long terms is tied to many factors represented mostly in three domains. **First,** the adoption of an immediate plan for fiscal consolidation as it is a main pillar to preserve a fixed exchange rate backed by enough deposit inflows, which requires a careful mix of increasing revenue and reducing current expenditure by an average of 1% a year to reach 5% of GDP to fix the debt to GDP ratio. This applies on the necessity to limit tax evasion and increase investment expenditure. **Second,** absorbing the risks that threaten financial stability in addition to enforcing the frameworks of combatting money-laundering and the financing of terrorism. Structural reforms constitute the **third** and most important domain due to their importance with the decline in the competitive and productive ability. These reforms conclude with the necessity to encourage investment in sectors that contribute to enhancing innovation and creating job opportunities. The IMF adds that improving the quality of reports and statistics remains a strong need as it results in attracting a larger number of investments and enforcing the making of policies.

The File of Oil and Gas

After a repetitive delay of more than four years for several reasons, Lebanon embarked on its promising project to exploit its resources of oil and gaz. Thus, it has signed the first two agreements for exploration and production at the beginning of 2018 with a consortium encompassing large international corporations commanding high experience in the East Mediterranean and with relevant technical and financial capabilities such as the French "Total", the Italian "Eni", and the Russian "Novatech". Excavation operations are expected to start at the beginning of 2019. After the first round of licenses in the Lebanese territorial water, where the number of qualified companies exceeded 53, which ended on 12/10/2017, and it is the last date to present the bidding requests, two offers were presented on Blocks 4 and 9. Each of them was evaluated from the technical and commercial standpoints to conclude that they are convenient to start the oil activities of the Lebanese state.

With the passage of the two decrees, a question is asked concerning the fate of the sovereign fund which remains a principal axis in this file due to the expected size of the Lebanese oil wealth, and as it commands various financial, economic, social and administrative benefits.

It is not possible for the extraction of oil and gas in Lebanon to be proper in the absence of this fund to prevent the possibilities of waste, corruption, mismanagements of revenues and the deprivation of the future generation from this wealth.

It is expected for the exploration and excavation to pave the way for general economic benefits starting with a local, cleaner and less costly source of energy than the other fossil sources aiming at the creation of a new sector in the Lebanese economy and thus creating job opportunities within the oil sector, given that the Lebanese law requires that 80% of the companies' employees be Lebanese with this process happening gradually. It is expected for this sector to be the source of general revenues composed of a package of royalties specified at 5% for gas, between 5% and 12% for oil, and from the government share of the profit that ranges between 65% and 71% in Block 4 and between 55% and 63% in Block 9, and finally from the profit tax standing at 20%. The extraction of oil and gas will lower the production costs for industrialists and for several economic activities and reduce the oil bill, or cause a decline in the merchandise trade deficit and thus improve the balance of payments.

III- PUBLIC FINANCES AND PUBLIC DEBT

3-1

After more than ten years without budget laws and spending based on the twelfth rule, and extra-budgetary approbations, the Lebanese parliament passed the budget law of 2017 number 66 (supplement of issue number 52 in the official gazette on November 17, 2017) limiting the expenditures to LBP 23,906 billion compared to LBP 16,416 billion for revenues, which means that the expected deficit is about LBP 7,490 billion, or around 9.4% of the expected GDP.

3.2

The actual figures for public finances in 2017 came better than the expectations of the budget law with the achievement of higher revenues and lower expenditure. The year 2017 was also better than 2016 concerning public finances as the budget deficit declined to 7.0% of GDP from 9.6% for the two years respectively. This is due to the fact that the pace of the expenditure increase, which was affected by the decline of transfers to the municipalities, came less than the increase in the pace of revenues that was enlarged, due principally to the exceptional income tax on profit paid by banks to the Treasury for the financial engineering operations in 2016. The general budget deficit stood at LBP 5,662 billion in 2017 compared to LBP 7,453 billion in 2016 and the realized primary surplus increased substantially to LBP 2,152 billion (2.7% of GDP) compared to a slight surplus of LBP 31 billion only (0.04% of GDP) in the two respective years.

PUBLIC FINANCES 2015 – 2017 (LBP BILLION)

	2015	2016	2017	Change 2016/2015 %	Change 2017/2016 %
Total Revenues (Budget +Treasury)	14,435	14,959	17,524	3.6	17.1
Total Expenditures (Budget + Treasury)	20,393	22,412	23,186	9.9	3.5
Overall Deficit	5,958	7,453	5,662	25.1	-24.0
Primary Surplus	+1,092	+31	2,152		
Overall Deficit / GDP %	7.9	9.6	7.0		
Primary Balance / GDP %	1.5	0.04	2.7		

Source: Ministry of Finance

3-3

As for total revenues, they have increased to LBP 17,524 billion in 2017 from LBP 14,959 billion in 2016 or by LBP 2,565 billion and 17.1%, and increased exceptionally to 21.8% to GDP compared to 19.3% respectively. Tax revenues increased by 16.8% and non-tax revenues by 14.0% and Treasury receipts by 31.7%. The share of each out of total revenues represented 70.7%, 22.1% and 7.3% respectively. The increase in tax revenue is primarily due to the increase in income tax on profits (the increase in the share of banks resulting from the financial engineering of 2016), given that other components increased though in differing degrees as shown in the table below. The share of income tax on profits increased to 12% of total revenues realized in 2017 and to 17% of tax revenue, whereas revenues from the value-added tax, which remain the primary revenue source to the Treasury, constituted 19.8% of total revenues and 28.1% of tax revenues.

3-4

It is to mention that the parliament passed law no. 64 (issue 50 of official gazette dated 26/10/2017) which stipulates the modification and introduction of some taxes and fees to cover the salary scale passed by Law no. 46 (issue of official gazette no. 37 on 21 August 2017) with its results showing consecutively an increase in Treasury revenue irrespective of its possible impacts on consumption and private investment. An important part of these taxes affects the banking sector through (a) the interest tax on bank deposits that have been raised from 5% to 7%, with enlarging the scale of bank placements, including interbank, affected by this tax and cancelling the discounts that were available, and (b), the tax on corporate profits that have been raised to 17% instead of 15% in addition to (c) eliminating the incentives to the companies listed on the stock exchange and raising the tax on dividends' distribution from 5% to 10%. We also mention that the value-added tax rate has been raised to 11% from 10%.

TOTAL REVENUES (LBP BILLION)

	2015	Share (%)	2016	Share (%)	2017	Share (%)
Taxes on income, profits and Capital gains	**2,887**	**20.0**	**3,015**	**20.1**	**4,201**	**24.0**
o/w: income tax on profits	1,103	7.6	1,143	7.6	2,101	12.0
tax on interest income	767	5.3	819	5.5	904	5.2
Taxes on Property	**1,179**	**8.2**	**1,224**	**8.2**	**1,413**	**8.1**
Domestic Taxes on Goods and Services	**3,717**	**25.7**	**3,773**	**25.2**	**4,079**	**23.3**
o/w: VAT	3,159	21.9	3,234	21.6	3,476	19.8
Taxes on International Trade	**2,064**	**14.3**	**2,117**	**14.2**	**2,163**	**12.3**
o/w : Customs	713	4.9	706	4.7	742	4.2
Gasoline	629	4.4	680	4.5	691	3.9
Other Tax Revenues	**483**	**3.3**	**468**	**3.1**	**525**	**3.0**
Tax Revenues	**10,330**	**71.6**	**10,597**	**70.8**	**12,381**	**70.7**
Income from public institutions and Government properties	**2,313**	**16.5**	**2,377**	**15.9**	**2,649**	**15.1**
o/w : Transfer from the telecom surplus	1,860	12.9	1,907	12.7	1,936	11.0
Other non-tax revenues	**992**	**6.9**	**1,015**	**6.8**	**1,217**	**6.9**
Non-tax revenues	**3,305**	**22.9**	**3,392**	**22.7**	**3,866**	**22.1**
Treasury receipts	**800**	**5.5**	**970**	**6.5**	**1,277**	**7.3**
Total Revenues	**14,435**	**100.0**	**14,959**	**100.0**	**17,524**	**100.0**

Source: Ministry of Finance

3-5

Total expenditure increased by 3.5% in 2017 to LBP 23,186 billion compared to a 9.9% increase in 2016. It represented 28.8% of GDP in 2017 as nearly was the case in 2016 (28.9%).
Primary expenditures, excluding debt service, increased to LBP 15,372 billion in 2017 from LBP 14,928 billion in 2016, or by 3%. This resulted from an increase in the allowances and salaries of public sector employees by 12% between 2016 and 2017, which increased their share of total expenditure to 35.4% in 2017 and to 10.2% of GDP. This development came as a result of starting to implement the law on salary scale. The transfers to the Electricity of Lebanon Company (EDL), increased by an amount of LBP 605 billion in 2017 after they dropped in the last two years. Thus, the cost of subsidizing electricity increased to 2.5% of GDP in the given year. Capital expenditures increased by 10.6% in 2017 given that their size is still low standing at LBP 1,193 billion in the mentioned year representing 5.1% of total expenditure and 1.5% only of GDP. It is expected that capital expenditures will increase in the coming years based on the application of the vision of the Lebanese government as presented in the CEDRE conference in terms of the ability to spend USD 1.6 billion yearly as an upper limit on the infrastructure projects in case of resorting to some required reforms, so that some of these projects will be conducted through the partnership between the public and private sectors.

3-6

An increase in debt service was recorded, resulting mostly from interest payments on domestic debt, and reaching LBP 7,814 billion in 2017 compared to LBP 7,484 billion in 2016, that is a 4.4% increase. The debt service represented 33.7% of total expenditure and 44.6% of total revenue in 2017 compared to 33.4% and 50.0% for these shares respectively in 2016. Debt service remained, as percent of average gross debt quasi stable at 6.7% in 2017 as it was approximately in 2016 (6.8%).

TOTAL REVENUES (LBP BILLION)

	2015	Share (%)	2016	Share (%)	2017	Share (%)
Debt Service	7,050	34.6	7,484	33.4	7,814	33.7
Primary Expenditures	13,343	65.4	14,928	66.6	15,372	66.3
o/w salaries, wages and other benefits (art. 13)	7,080	34.7	7,335	32.7	8,218	35.4
transfers to EDL institution	1,711	8.4	1,397	6.2	2,002	8.6
Capital expenditures	888	4.4	1,079	4.8	1,193	5.1
Transfers to municipalities	936	4.6	1,555	6.9	622	2.7
Total Expenditures	**20,393**	**100.0**	**23,412**	**100.0**	**23,186**	**100.0**

Source: Ministry of Finance

3-7

Concerning the budget law of 2018, which was passed by the Parliament on 29/3/2018 (number 79 in the official gazette supplement no 18 dated 19 April 2018), expenditures were estimated in the amount of LBP 23,891 billion with the addition of an advance treasury of LBP 2,100 billion to the Electricity of Lebanon Company (EDL), so that the amount of total expenditure becomes LBP 25,991 billion, out of which are LBP 10,108 for salaries and allowances and LBP 8,362 billion for debt service and LBP 2,171 billion for capital expenditures in comparison to revenues of LBP 18,687 billion, out of which LBP 14,276 are tax revenues. So the budget deficit is estimated at LBP 7,304 billion or 28.1% of total expenditures. Knowing that the auditing of public accounts for the previous years is still going on to find a constitutional and legal solution.

Overall, the passing of the two budget laws of 2017 and 2018 implied possible positive repercussions on monetary and fiscal policies and on the reputation of the country towards the international organizations and the foreign investors. This is considered a step at the level of the return of fiscal discipline to the work of the government. The public budget is an essential tool for economic and social development and has other functions than to confine the needs and revenues of the government, and it is used as a means to restrain the fiscal policy of the nation and to achieve the goals of the government and implement its economic policy.

3.8

It is to mention that on 16 August 2017, the Lebanese Parliament passed the law on partnership between the public and private sectors (no. 48). This partnership constitutes a tool for recovery and economic development and helps to rehabilitate and develop infrastructure which is considered necessary to activate the economy and create job opportunities. However, it requires confidence, stability, strong institutions, a clear legal framework, and the appointment of regulatory bodies and boards of directors for all institutions according to laws. Financing the partnership projects directly may possibly limit corruption risks or irrational expenditure. These projects are of major importance to the granting parties given that the partnership law between the public and private sectors contributes to the improvement of the efficiency of projects, transparency, and accountability by encouraging the private sector to enroll in the proposed projects. We mention that the CEDRE conference expects investment opportunities from this partnership (estimated at USD 5 billion) hoping that the involved companies provide fresh money to the country.

PUBLIC DEBT

3-9

At the end of 2017, gross public debt reached LBP 119,905 billion (the equivalent of USD 79.5 billion) compared to LBP 112,910 billion (USD 74.9 billion) at the end of 2016, thus increasing by 6.2% which is close to the increase of 6.5% in the previous year. The increase in gross public debt in 2017 was due to the increase in the public debt in LBP by LBP 3,549 billion which reached LBP 74,077 billion at the end of the given year, representing 61.8% of total debt, and the increase in public debt in foreign currency by an amount equivalent to LBP 3,446 billion reaching the equivalent of LBP 45,828 billion or 38.2% of total public debt at the end of the same year. Thus, the total increase in gross public debt reached LBP 6,966 billion in 2017 surpassing the budget deficit of LBP 5,662 billion in the same year.

3-10

The debt to GDP ratio increased to 148.9% at the end of 2017 from 145.5% at the end of 2016. This involves exorbitant costs especially that interest payments on debt exhaust around 63% of tax revenues and the equivalent of 9.7% of GDP. Weak economic growth in addition to an increase in public debt at a quick pace called for the necessity of correction to ensure stability in debt dynamics. Thus the reason for holding the CEDRE conference which is expected to provide the Lebanese government with around USD 11 billion to be used to finance investment projects on condition of starting the necessary reforms. Capital expenditure and conducting reforms represent two primary factors to fix the debt to GDP ratio as a first step and gradually reducing it in a following period.

3-11

However, when market debt is computed, i.e. debt excluding the holdings of the BDL, public institutions, bilateral and multilateral debt, and debt of Paris 2 and Paris 3, the debt to GDP ratio drops to around 89.4% at the end of 2017. Knowing that the factor that reduces the risk of public debt is its distribution and concentration with resident subscribers as they are certainly accustomed more than others with the country's political, economic and social conditions.

3-12

Net public debt computed after deducting the public sector deposits in the banking system, reached LBP 104,500 billion (USD 69.3 billion) at the end of December 2017, increasing by 5.9% compared to an increase of 6.3% in 2016. Public sector deposits at the BDL increased from LBP 8,892 billion at the end of 2017 compared to LBP 8,312 billion at the end of 2016 or by an amount of LBP 580 billion after having increased by LBP 159 billion in the previous year. The state deposits in LBP at the BDL in the account no. 36, of which collected taxes and fees increased by LBP 2,366 billion in 2017 to reach LBP 9,600 billion at its end. Other accounts in LBP, representing interest on subscriptions in Treasury bills also increased by LBP 200 billion. The balance of the state account at the BDL which remains positive, allows the financing of future deficits in case capital inflows from abroad slowed down or were reduced. The Treasury accumulates, through its borrowing to cover public deficit, amounts in its accounts at the banking system that exceed its current financial needs to secure its longer-term financial ones in case the conditions worsened and got more complicated.

PUBLIC DEBT 2015-2017 (END OF PERIOD – LBP BILLION)

	2015	2016	2017	Change 2016/2015 %	Change 2017/2016 %
Gross Public Debt	**106,031**	**112,910**	**119,905**	**+6.5**	**+6.2**
Distribution of total public debt:					
Debt in LBP	65,195	70,528	74,077	+8.2	+5.0
Debt in Foreign Currencies	40,836	42,382	45,828	+3.8	+8.1
Public Sector Deposits at the Banking System	13,227	14,268	15,376	+7.9	+7.8
Net Public Debt	**92,804**	**98,642**	**104,529**	**+6.3**	**+6.0**

Source: BDL

3-13
As for local currency public debt, the share of banks decreased to 37.5% at the end of 2017 from 41.9% at the end of 2016 and the share of the non-banking sector to 14.5% from 15.3% respectively, against an increase in the share of the BDL to 48.0% from 42.7% on the two mentioned dates respectively. The portfolio of commercial banks in LBP treasury bills witnessed variations in 2017 as banks preferred not to renew maturing bills but to increase their deposits at the BDL in the framework of managing liquidity and profitability. The BDL used to compensate for deficits when needed by intervening buying the offered surplus of bills to ensure market balance.

3-14
As for financing foreign currency public debt, 92.4% of it comes from Eurobonds at the end of 2017 as was nearly the case at the end of 2016 (92.6%). Concerning the portfolio of commercial banks in Eurobonds, it declined by the equivalent of USD 1,205 million in 2017 after a decline of USD 2,261 million in 2016 due to the banks' unwillingness to renew maturing bonds, on one hand, and as some banks resorted to selling Eurobonds to foreign investors as part of managing foreign currency liquidity, on the other. This portfolio witnessed variations in 2017 reaching an amount of USD 14,178 million at the end of the given year compared to USD 15,383 million in the previous year. Thus, the share of commercial banks in Eurobonds portfolio declined to 50.5% from 59.1% out of the total Eurobonds portfolio at the end of the two periods respectively.

3-15
The interest rates on Treasury bills in LBP stood stable during 2017 compared to the previous year except for the exceptional issuances in the amount of LBP 3,000 billion at an interest rate of 1% that the BDL subscribed to.

YIELDS ON LBP TREASURY BILLS IN 2017

3-M	6-M	12-M	24-M	36-M	60-M	84-M	120-M
4.44%	4.99%	5.35%	5.84%	6.50%	6.74%	7.08%	7.46%

3-16
Due to that, the weighted average interest rate on the total portfolio of Treasury bills in LBP witnessed some variations declining to 6.65% at the end of 2017 compared to 6.92% at the end of the previous year, whereas the weighted average life of the portfolio increased to 1,420 days (3.9 years) from 1,269 days (3.5 years). In the Eurobonds market, the weighted average interest rate on this portfolio slightly increased to 6.49% from 6.46%. The weighted average life on this portfolio increased to 7.07 years from 6.19 years in the two consecutive dates.

IV- MONETARY POLICY DEVELOPMENTS

4-1
The monetary policy adopted in Lebanon remains specifically directed to support tying the exchange rate of the LBP to the USD, which helped and still is on securing confidence as well as financial, economic and social stability despite its association with the lack of economic growth. Thus, the main priority of the BDL is to preserve an appropriate level of foreign currency reserves through the usage of all available tools. In addition to the efforts spent by the BDL to preserve the reliability of the peg, it worked in a parallel and growing manner at providing support for the government and the economy. It used to subscribe when needed in Treasury bills in LBP and foreign currencies in the primary market, and used to provide liquidity sometimes to the government at a lower cost than the market one[1] in addition to providing its payments in foreign currencies. On the other hand, the BDL provided in the last years specifically since 2013, or in the period in which the economy registered weak economic growth rates, a stimulating package to the private sector approaching USD 5.5 billion until the end of 2017 represented in pumping liquidity at low interest rates (1%) to banks to be relent to households and companies with banks carrying the credit risk, in addition to the available mechanisms that provide incentives to banks by allowing them to use required reserves[2]. Thus, the BDL has been practicing a non-conventional monetary policy aiming clearly at supporting economic growth and creating employment opportunities. Added to the non-conventional monetary policy are the multi-objectives financial operations with different sizes that the BDL has implemented with banks in 2016 and 2017, which had a large role in preserving monetary stability.

1 The latest of which was the subscription in Treasury bills in an amount of LBP 3,000 billion at only %1 during the months of November and December 2017.

2 The incentive mechanism that the BDL provides to banks changed so that it requires that the BDL supports interest rates while banks provide loans from their resources effective the beginning of 2018, whereas the mechanism supporting loans subject to reduction from the required reserves and ones receiving a reduction from the obligations subject to required reserves stopped in the fourth quarter of 2017.

4-2

Contrary to the previous years, the monetary situation in 2017 did not keep its usual stability affected in November by the resignation of the Prime Minister from abroad. The BDL however was able through its existing capacities and experience in crisis management to preserve monetary stability, especially the fixing of the exchange rate of the LBP to the USD, and showed one more time its large capability to resist and withstand difficulties. The sudden resignation of the Prime Minister shocked the country and had temporary and continuing repercussions on the monetary and financial conditions. The crisis impacted quickly the currency market as the LBP witnessed pressures not experienced for the last 10 years[3], or since the assassination of President Rafic Hariri in 2005 and the July war of 2006, due to deposit conversion from the national currency to the USD by an estimated amount of USD 2.8 billion. In parallel, it was natural for the interbank rate –which recorded normal levels for the first ten months remaining in the region of 3 to 4% - to take an increasing trend from the beginning of the crisis reaching in some operations 125%, which are levels not witnessed for a long time, due to the need of banks for liquidity in LBP placed with the BDL for long maturities, and due to the fact that the BDL, in the context of liquidity management, took measures securing more discipline in the markets. Some deposits outflow was also recorded but by insignificant sizes not exceeding 2% of total deposits, that was largely limited by bank administrations based on their tight cooperation with the BDL and their strong relationship with large depositors. This crisis caused an increase in bank interest rates especially on deposits as interest rates on LBP deposits increased by 200 to 300 basis points[4] to encourage depositors to keep their deposits in LBP upon maturity or even to increase the maturity. Interest rates on USD deposits also increased but by a lower percentage to limit the transfer of funds outside Lebanon, whereas the crisis did not reflect on the average interest rates on Treasury bills as its impact remained restricted to bank accounts.

What is worth mentioning is that with the abatement of the political crisis mid-December 2017, the currency market witnessed a return to its normal activity with also a halt in the activity of capital outflows. Thus, the sudden developments of November 2017 would have created an additional real experiment and not a theoretical one to absorb and overcome the crisis in which the banking system succeeded and showed its ability to resist.

4-3

The Measures of the BDL in 2017: Preventive/precautionary financial operations and continuous arrangements to contain the November crisis

In general, most measures taken by the BDL center around strengthening its assets in foreign currencies and affecting liquidity, and this for the necessities of monetary stability.

Preventive Financial Measures

The BDL continued in 2107 its preventive financial measures with banks, which permitted pursuing the attraction of funds to Lebanon through incentivizing banks to place more foreign currencies at the BDL, knowing that they differed in their mechanisms and sizes from the financial engineering implemented in 2016. These operations aimed primarily at reinforcing the assets of the BDL in foreign currencies and was accompanied by a careful management of liquidity in LBP[5] and the prevention of its usage in speculative operations. This comes in the framework of the slow-down registered in net capital inflows to Lebanon compared to the previous years and the continuing large financial needs of the economy in foreign currencies, in view of the large deficit in the current account and the high levels of budget deficits and public debt, in addition to the increase in the international average interest rates on the USD and other pressing factors.

These operations allowed banks first, and since June 2017, to undertake placements with medium maturity in LBP at the BDL at average interest rates exceeding by 1% the trend of return on condition that they have deposited in it similar amounts in USD with medium to long-term maturities at average interest rates exceeding the market ones or the trend of return by 0.5%. The conversion of some of the bank liquidity in LBP to medium term placements allowed the reduction of any future expected pressure. Second, they allowed banks, and since September 2017, to benefit from loans and facilities in LBP at an average interest rate of 2% so that they are used to buy Treasury bills in LBP (or Lebanese financial instruments) in the primary or secondary market, in return for long-term deposits for banks at the BDL in foreign currencies, which secures banks a good total return from this operation, and the state the financing it needs.

It is to mention that banks were able to secure foreign currencies in the framework of the implemented financial operations since June 2017, primarily from withdrawing part of their liquidity at correspondent banks and placing it at the BDL, and attracting new funds in foreign currencies from customers, and to a lesser extent from selling part of their portfolio in Eurobonds or attract additional deposits from the non-resident financial institutions with the Bills as collateral.

Also in the framework of precautionary measures, we remind that the Ministry of Finance has issued in 2017, and in coordination with the BDL, Eurobonds in the amount of USD 3 billion[6] – which was the largest issuance in its history - for the purpose of financing a large part of government dues in foreign currencies during the remaining period of the mentioned year. The BDL allowed banks to discount Certificates of Deposits that it had previously issued for the purpose of subscribing in Bills issued in March 2017, which prevents affecting or pressuring banks' liquidity in foreign currencies in addition to reducing the cost of the Certificate of Deposits for the BDL. With the permission of the BDL to banks to discount the Certificates of Deposits to subscribe to the Eurobonds issuance of March 2017, it could be said that it had secured in advance the foreign currencies that might be needed by the government[7] in the future.

...And Others Absorptive

The BDL took many measures to contain the sudden political crisis which emerged at the beginning of November, in cooperation with banks. In addition to its intervention in the currency market selling USD in the amounts needed to preserve the stability of the LBP exchange rate, the BDL incentivized banks to limit the conversion of LBP to USD and extend the maturities of deposits in LBP, by bearing the additional interest rate cost that may be borne by the bank that range between 2 and 3%[8] in case the depositor kept the deposit in LBP upon maturity and for a period of no less than 3 months, and this through increasing interest rates on bank placements at the BDL in LBP. Actually, this measure allowed the extension of the maturity of deposits from 40 days to 125 days on average[9] which

3 Knowing that it came less severe than 2005 and 2006.

4 In case their maturities were extended to three or more months.

5 Some of which resulted from the financial operations.

6 After the Parliament passed in November 2016 Law number 72 which allowed the government to issue Treasury bills in foreign currencies in an amount not to exceed USD 3 billion, and this law reduces the reliance on the BDL to secure foreign currencies.

7 Subscription of USD 700 million was made in these bills through the Certificates of Deposits in USD.

8 Depending on their terms of maturities.

9 In April 2018.

relieves liquidity management to a great extent as it reduces possible pressure in case of any negative development. The BDL increased as well the average interest rates on bank placements in it in USD, but by a moderate amount, so that banks can translate it to the interest rates on deposits to limit deposit outflows. Banks played a major role in the successful repelling of the crisis through their solid and effective cooperation with the monetary authorities, their strong relationships with customers, and their high liquidity in foreign currencies which allowed them to accommodate the requests of deposit outflows with extreme ease.
On the other hand, the issuance of the Ministry of Finance in November 2017 and in coordination with the BDL, Eurobonds in the amount of USD 1.7 billion in return for exchanging or extinguishing Treasury bills in LBP to be held by the BDL in its portfolio, contributed to enforcing its foreign currency assets to count them in the portfolio of financial instruments, and to containing the ongoing crisis. This operation of exchange/trade allowed the extension of the maturities of the portfolio of Bills and the reduction of the relatively close dues in LBP, as the exchanged bills were supposed to mature during the period 2018-2025.

4-4
On some of the results of the measures of the BDL

- The BDL was able through the precautionary and absorptive measures implemented in 2017, to strengthen its gross foreign currency reserves that increased to USD 35.8 at the end of 2017 compared to 34.0 billion at the end of 2016, excluding its placements in international securities in foreign currencies that have slightly increased to USD 6.2 billion at the end of 2017 in comparison to USD 5.6 billion at the end of 2016 given that they include Eurobonds of the Lebanese government. Its gross foreign assets reached USD 42.0 billion at the end of 2017 compared to USD 40.7 billion at the end of 2016. We also mention in this framework that the BDL holds a large amount of gold reserves ranking it as 19th internationally and as 2nd in the MENA region in terms of country reserves according to the list published by the “World Gold Council” in April 2018, knowing that the value of the gold reserves of Lebanon increased to around USD 12.0 billion at the end of 2017 in comparison to around USD 10.7 billion at the end of 2016 with the increase in the price of gold internationally over the two mentioned dates due to the increase in investment demand (especially due to the weakness of the USD at that time, and from fears of geopolitical instability especially in the North Korean environment..). As it is known, foreign currency and gold reserves are some of the most important elements supporting confidence in the national currency. The foreign currency reserves held by the BDL are considered adequate to defend the value of the LBP against the USD and face any possible pressures such as the ones of November 2017, based on the acknowledgement of the most important international financial institutions including the IMF.

- **The Increase in Bank Deposits at the BDL**
Commercial Banks deposits at the BDL continued to increase in 2017 – by around 16%-, in LBP and especially in USD, in light of the financial operations implemented in the mentioned year and the increase in interest rates on bank placements at the BDL due to the occurring political crisis. Concerning bank deposits in foreign currencies at the BDL, they increased significantly in 2017[10] by an amount exceeding USD 10 billion according to our estimates, contributing to a great extent at reinforcing the BDL’s foreign reserves, and thus strengthening currency stability. The increase in 2017 came especially in the form of term deposits due to the nature of the financial operations implemented by the BDL in the given year. The BDL also issued in 2017 Certificates of Deposits in USD but in a much less extensive manner than in 2016, so that the portfolio of these Certificates in USD increased to USD 23.2 billion at the end of 2017 compared to USD 21.9 billion at the end of 2016 and USD 9.1 billion at the end of 2015. It is to remind that the increase in these deposits in 2016 came about especially due to the issuance of the BDL of Certificates of Deposits in USD in an extensive manner since May 2016 in light of the financial engineering implemented then (consult Annual Report 2016).

At another level, the BDL uses the Certificates of Deposits in LBP on many occasions as a principal and effective tool to control liquidity and influence the structure of deposits. In 2017, the portfolio of Certificates of Deposits in LBP issued by the BDL registered a moderate increase to LBP 35,865 billion at its end compared to LBP 34,631 billion at the end of 2016, or by an increase amounting to LBP 1,234 billion, resulting from issuances amounting to an estimated LBP 5,000 billion from the categories of long maturities (with a larger intensity than the issuances of 2016) compared to dues close to LBP 4,000 billion according to our estimates, mostly from the category of seven years that were issued in 2010. Knowing that the last month of 2017 witnessed net issuances in the amount of LBP 2,068 billion in the framework of managing liquidity in LBP due to the November crisis, concentrating on the long-term categories of 15, 20, and 30 years.

- The portfolio of Treasury bills in LBP owned by the BDL registered a continuous increase in the last years, as this portfolio reached at the end of 2017, LBP 35,580 billion, which is the highest level historically, compared to LBP 30,150 billion at the end of 2016, and this despite the exchange operation of bills in LBP from the portfolio of the BDL with Eurobonds amounting to USD 1.7 billion in November 2017. The share of the BDL out of the total portfolio of Treasury bills increased to 48.2% at the end of 2017 which is also its highest historical level, compared to 42.9% at the end of 2016. Its increase in 2017 came to accommodate the financing needs of the government and the preservation of interest rates on Treasury bills in all their categories, especially with the increase in the placements of banks at the BDL in LBP resulting from the implemented financial operations in summer 2017 and the measures taken by the BDL as a result of the November crisis to manage liquidity in LBP, and also as a result of the subscription of the BDL in Treasury bills amounting to LBP 3,000 billion at a return of 1% only in the last two months of 2017. We mention that the increase in BDL’s portfolio of bills in 2016 was the result of discount operations of Treasury bills owned by banks in the framework of the financial operations that it implemented then.

4-5
Preparing for the next phase

The financial operations implemented by the BDL in 2016 and 2017 remain temporary solutions, despite their strengthening of the assets of the BDL in foreign currencies, and thus reinforcing its ability to defend monetary stability, as securing the necessary financial needs of the economy in foreign currencies is a continuing operation, especially in light of the upward trend of the US interest rates, and the heightening in the competition over liquidity among the regional financial institutions, and in light of the increase in the world oil prices, and the growing fears related to the stability of the region. Thus, the BDL embarked in May 2018, in cooperation with the Ministry of Finance, on an operation represented by the issuance of the Ministry of Eurobonds in the amount of USD 5.5 billion that were exclusively subscribed to by the BDL, out of which it sold the amount of USD 3.0 billion to banks while preparing this report. This operation

10 As in the previous year.

contributes to the strengthening of the reserves of the BDL in USD and the securing of the needs of the government to finance its dues in foreign currencies in the forthcoming June and November. The BDL and the Ministry of Finance are conducting in parallel a swap operation by which the BDL returns to the Ministry an amount equal of LBP 8,240 billion in Treasury bills at an interest rate of 7% on average while the Treasury issues an equal amount of bills at an interest rate of 1%, so that the Treasury can save nearly LBP 500 billion from debt service.

The BDL on the other hand is working on changing the legal framework that governs the issuance of Certificates of Deposits in foreign currencies in a manner allowing banks to sell them in return for liquidity, to ease the banking sector and the BDL. There is also a new approach to the interest rate policies represented by the showing of the BDL on its screen the interest rates that it would like to work with the banks on, and which will take into account, out of many issues, the international developments concerning interest rates, so that banks can run on this basis the relationship with their customers.

In other words, there is a new tendency to have some increase in interest rates to ensure the sufficient financial flows needed by the country in light of the existing challenges. In summary, these overall operations are continuously increasing in size, cost and complexity in every period to make the country gain more time.

Also concerning the next period, it has become necessary even pressing for the government to quickly launch the reform measures that it is planning on conducting and that it expressed in the paper submitted to the CEDRE conference, of which mainly what is related to reducing the deficit to GDP ratio by 5 percentage points in the next five years as continuing and enlarging the deficit is not to the benefit of financial stability in the country, and to receiving the soft loans promised by the international countries and parties, to launch the economic activity and secure the sustainability of public debt especially reducing the burden off monetary policy and the BDL which guided in the last years the economic policy of Lebanon, with a quasi- absence of the effective government decisions.

4-6
Monetary Aggregates

The M3 monetary aggregate growth recorded a severe slowdown to 4.2% in 2017, negatively affected by the crisis of November 2017 that resulted in the temporary outflow of some deposits from Lebanon, in comparison to a growth rate of 7.4% in 2016 tied to the financial operations implemented by the BDL in the stated year, and was higher than the recorded rates for the period 2011-2015.

M3 reached LBP 208,613 billion at the end of 2017 with its dollarization rate increasing to 62.08% at the end of the mentioned year from 58.83% at the end of 2016 or by 325 basis points and this is natural due to the conversion of bank deposits in LBP to foreign currencies caused by the November crisis. It is possible to summarize the major components that have contributed to the increase of M3 in 2017 by LBP 8,420 billion -which represents only 60% of its increase in 2016- as follows:

EVOLUTION OF MONEY SUPPLY AND ITS COUNTERPARTS (END OF PERIOD – BILLION LBP)

	2015	2016	Change 2016/2015 %	2017	Change 2017/2016 %
Money in LBP (M1)	9,042	10,159	+1,117	10,655	+496
Money and quasi-money in LBP (M2)	78,620	82,428	+3,808	79,113	-3,315
Money and quasi-money in LBP & FC (M3)	**186,360**	**200,192**	**+13,832**	**208,613**	**+8,420**
Counterparts					
Net foreign assets	46,608	49,712	+3,104	49,166	-546
o/w : gold	14,846	16,138	+1,292	18,033	+1,894
foreign currencies	31,762	33,574	+1,812	31,133	-2,441
Net claims on public sector	70,688	76,778	+6,090	78,246	+1,469
Valuation adjustment	-6,401	-7,707	-1,306	-9,726	-2,018
Claims on private sector	75,695	80,188	+4,493	85,189	+5,001
Other items (net)	-229	1,222	+1,451	5,737	+4,515

Source: BDL

Claims on the private sector increased by LBP 5,001 billion or by more than the increase in the previous year and regained its role as the most important contributor to money creation, after being the second largest contributor in increasing monetary aggregate M3 in the previous two years. In their turn, other net items on the balance-sheet of the banking system increased by an amount of LBP 4,515 billion representing monetizing financial obligations to be the second largest contributor to money creation. Net claims on public sector increased by LBP 1,469 billion or by less than its one-fourth increase in the previous year to contribute in their turn positively to money creation. In return, the net foreign assets of the banking system (excluding gold) decreased by USD 1.6 billion to return to the declining trend prevailing over the period 2011-2015 with their impact being thus contractionary on the monetary aggregate.

4-7
Inflation

According to the Central Administration of Statistics, the inflation rate was +4.48% in 2017, after being negative in 2016 and 2015 as it respectively reached -0.82% and -3.75%. This comes within the goals set by the BDL concerning the inflation rate (+4.5%).
The increase in prices in 2017 came in parallel to the reoccurring increase in world oil prices (+23.3%), and food products prices (+8.1%), after their decline in the preceding years, in addition to the increase in the average exchange rate of the euro in comparison to the USD even moderately. In its part, the BDL works continuously at monitoring and sterilizing liquidity in order to contain the inflationary pressures that could result from it. The continuous decline as well in the domestic demand in general (compared to the potential domestic output) helped in not pressuring prices upward.

It is expected that year 2018 will witness additional inflationary pressures caused by external factors, with the anticipation of a continuous increase in the average prices of oil, food products and metals in comparison to 2017, or due to internal factors related to the implications of passing the salary scale and the tax measures that were passed in the last quarter of 2017. Therefore, and in parallel to the weak expected economic growth in Lebanon, and with the commitment of the BDL to contain inflation especially after its tight measures of liquidity management lately, the inflation rate will probably remain under control in 2018 as the IMF expected in its latest report on the World Economic Outlook for the CPI in Lebanon to increase by 4.3% in the current year. It is to mention that the CPI issued by the Central Administration of Statistics recorded an increase of 5.8% from April 2017 to April 2018.

V- EXTERNAL PAYMENTS

Current Account and Balance of Payments

5-1

According to the latest available information provided by the BDL, the estimated current account deficit in Lebanon stabilized at USD 8.2 billion in the first nine months of 2017 compared to USD 8.3 billion in the same period of 2016 (USD 10.6 billion in the whole year of 2016) as the trade of goods deficit (FOB)[11] decreased to around USD 10.0 billion from USD 10.7 billion over the two mentioned periods (USD 14.0 billion in 2016), whereas the estimated surplus in the balances of services, current transfers and income decreased slightly to around USD 1.8 billion from around USD 2.4 billion (USD 3.4 billion in 2016). Thus, based on that and on the results of the merchandise trade for the whole 2017, it is estimated that the current account deficit increased to around USD 11.5 billion and its share to GDP increased to around 22.4% in 2017 compared to 20.8% in 2016.

Given that the latest estimates of the IMF concerning the current account deficit, which are ones that mostly differ from those provided by the BDL, pointed-out to the increase in the current account deficit to around USD 12.9 billion in 2017 compared to USD 11.6 billion in 2016, and the increase in this deficit to GDP ratio to 25% compared to 23.3% for the two mentioned years respectively.

5-2

The expatriates' remittances to Lebanon increased by 4.6% in 2017 to reach USD 8.0 billion based on the latest estimates of the World Bank compared to USD 7.6 billion in 2016 given that they sometimes differ from the figures of the IMF and BDL. The net current transfers stood at around USD 3.9 billion in 2016 which is the latest information available about this issue, and this level is close to the one recorded in 2015 standing at USD 3.8 billion. According to the BDL, until September 2017, these net transfers recorded an increase of 11% compared with the same period of 2016.

The World Bank attributed the increase in the remittances in 2017 to the improvement in the economic conditions in some of the countries where the Lebanese are employed in addition to the return of oil prices to their increase which will reflect positively on the growth outlook in the Gulf countries. The remittances to Lebanon constituted, according to the same source, 15.1% of the GDP in 2017 which is the second highest ratio in the MENA region and one of the highest ratios in the world. Lebanon occupied in 2017 the 18th position in the world and the second highest position in the region behind Egypt in terms of the amount of remittances. The systematic and level of these remittances reflect the size of the Lebanese Diaspora in all parts of the world, its high quality in all respects and its continuous social and economic ties to its families and country.

5-3

The high current account deficit in Lebanon, which is determined largely by the trade of goods deficit, is financed by the surplus in the capital and financial accounts, i.e. through the net capital inflows in various forms from direct investments, portfolio investments, deposits at banks, net loans from abroad to the public and private sectors, and others. Based on the levels of current account deficit stated above, the net capital inflows to Lebanon would have decreased in 2017 compared to 2016 (estimated at around USD 12.0 billion in 2016).

5-4

Concerning the foreign direct investment whose size is estimated differently by various sources, several reports agreed on their decline to Lebanon in the last years due to the internal and regional pressures.

The available information provided by the BDL until September 2017 which is adopted in the report of UNCTAD on investments in the world, pointed-out that net foreign direct investments flowing to Lebanon increased a little to USD 2.2 billion in 2017 (4.2% of GDP) compared to USD 2.0 billion in 2016 (3.9% of GDP) and USD 1.7 billion in each of 2015 and 2014 (3.5% of GDP) knowing that the average for the three years 2008-2010 witnessed for comparison purposes net foreign direct investments approaching on average USD 3.2 billion annually. Foreign direct investments flowing to Lebanon increased slightly according to the same source amounting to USD 2.7 billion in 2017 (5.1% of GDP) in comparison with USD 2.6 billion in 2016 (also 5.1% of GDP) and USD 2.4 billion in 2015, knowing that the average for the years 2008-2010 had exceeded USD 4.0 billion annually. It is to mention that foreign direct investments usually finance a large part of the current account deficits and are largely concentrated in the real estate sector differing from the nature of foreign direct investments in many emerging countries where they are diverse affecting several economic sectors.

5-5

In conclusion and despite its acceptable level, the net capital inflows in 2017 were not able to cover the current account deficit, causing a slight deficit amounting to USD 156 million in the balance of payments according to the figures issued by the BDL. It is to remind that net capital inflows were able to cover in 2016 the current account deficit and to cause a surplus in the balance of payments reaching USD 1.2 billion, and this after consecutive deficits during 2011-2015 accumulating to more than USD 9.4 billion.

Despite the fact that Lebanon still enjoys a high level of liquid assets in foreign currency which has been reinforced further in 2016 and 2017, this does not excuse the concerned governmental and parliamentary authorities from acting swiftly to avoid weakening or depleting foreign currency reserves and thus weakening the immunity of the monetary situation and the need to largely increase the interest rates -as is happening in Turkey, Argentina and other emerging countries- or resorting to costly new financial engineering operations hoping to attract capital inflows in a way that permits the continuation of the prevailing economic model. Thus, there is a pressing need for the new government to start as soon as possible to implement the structural reforms and the ones concerning public finances as it promised in the CEDRE paper, as this has a large positive influence on capital inflows to Lebanon in all their aspects, with some concerning the obligations of the Arab and foreign countries and parties in the conference.

11 The deficit in the merchandize trade recorded in the balance of payments differs from the one published by the Lebanese Customs that adds the following: re-exported goods, goods exported temporarily for processing (re-cycling), and re-exported goods after preparing them locally and repairs on goods.

Foreign Trade

5-6

According to Customs Higher Council, the value of imported goods reached USD 19.6 billion in 2017 compared to USD 19.1 billion in 2016 increasing by an amount of USD 463 million or 2.4%, affected by the continuation of the increase in the world prices of a large number of imported products from oil, food products and others, in addition to the slight increase in the average price of the Euro against the USD, whereas the total imported quantities remained in general without major change compared with 2016. To give an example, there was an increase in the imported quantities of mineral products which are constituted for the most of petroleum derivatives by 1.6% in 2017, whereas the value of these imports increased by a slightly larger figure reaching 3.4% due to the increase in the average price of petroleum derivatives. It was also affected by the remarkable decrease in the value of imports of precious and semi-precious stones and precious metals (- USD 259 million), which is largely tied to a great extent to its export activity which also largely decreased at the same pace.

The imported quantities registered a slight increase of 0.2% to reach 18,975 thousand tons in 2017 compared to 18,928 thousand tons in the preceding year with the increase in the quantities imported of many consumer and productive commodities namely vegetable products, grease, animal or vegetable oil, transportation equipment, chemical products, machines, electrical equipment and tools, mineral products and others, backed by the additional consumption needs in the country resulting from the presence of large numbers of Syrian refugees. In comparison, some imported quantities declined such as base metals and articles of base metals, industrial food products, shoes, headdresses, paper products....

Even after careful examination of the change in the type of quantities imported or after excluding some commodities that weigh heavily or that were exceptional during the period of the study to provide a clearer picture on the development of other commodities, we find that the quantities imported did not witness in 2017 any noticeable change to remain at the level reached in 2016. For the sake of an example, after excluding the mineral products and the vegetable products which witnessed an increase in 2017 and also the base metals and articles of base metals which recorded a large decrease, the imported quantities of other goods increased by 0.3% in 2017.

Thus, the value of imported products slightly increased in 2017 affected generally by the price effect as some commodities witnessed an increase in their world prices whereas the quantities imported remained in general at the level recorded in 2016, which clearly reflects the continuous weak economic growth in Lebanon. In other words, had it not been for the increase in world prices of some commodities in 2017, the import bill would have stayed at its level recorded in 2016.

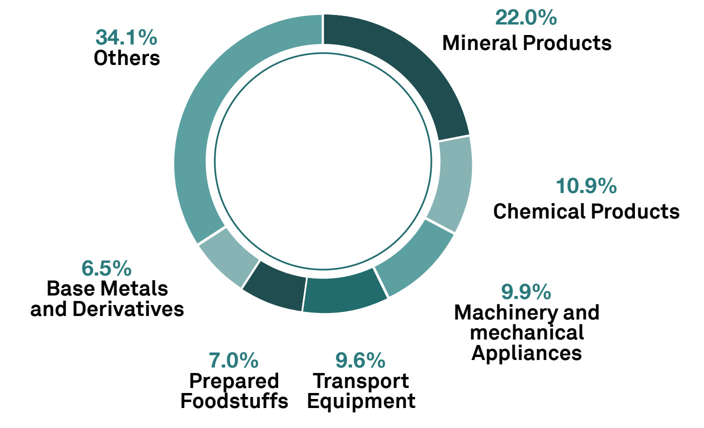
IMPORTS OF GOODS

	2015	2016	2017
Value – USD million	18,595	19,119	19,582
Change (%)		+2,8	+2,4
Quantities – Thousand tons	17,245	18,928	18,975
Change (%)		+9,8	+0,2

Source: Customs Higher Council.

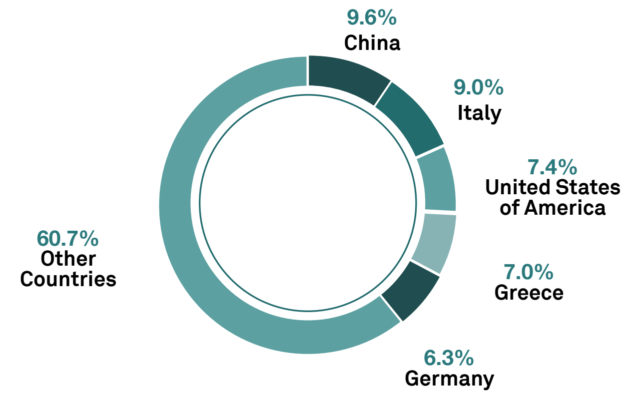
The two graphs below summarize the distribution of imported goods by type and country of origin in 2017.

MAIN IMPORTED PRODUCTS IN % OF TOTAL IN 2017



Source: Customs Higher Council.

IMPORT BY COUNTRIES OF ORIGIN IN % OF TOTAL IN 2017



Source: Customs Higher Council.

5-7

In another context, the value of exported goods slightly decreased to USD 2,844 million in 2017 compared to USD 2,977 million in 2016, or by an amount of USD 133 million and by 4.5%. This outcome was obviously affected by the decrease in the exports of precious and semi-precious stones and precious metals by USD 242 million and by more than 29% for the given year. After excluding them, the value of exported commodities would have registered a large increase of 5.1% and an amount of USD 109 million in 2017, due to the quantity factor as we will see later on, whereas the price factor was contractionary in general concerning exports as influenced by the exported commodity basket.

Except for exports of precious stones and precious metals, the value of exports by type of commodities recorded a change but by a very moderate amount. Regular commodities and their products witnessed the largest change in terms of value, increasing by the equivalent of USD 87 million. It is to mention in this context that the closure of the crossing of Nassib in 2015 had a negative impact on Lebanese commodity exports to the Arab countries, knowing that these exports though witnessed some improvement in 2017 but from a weak base[12].

As for the quantity of exports, it registered an increase in 2017 by 16.8% reaching 1,937 thousand tons. Actually, the largest part of the customs items witnessed a varying increase in the quantities of their exports among items, with the most prominent being the item of base metals and articles of base metals that represented around 60% of the increase in the total exported quantities. Getting into the details and isolating some items, we find that the increase in quantities exported was less severe than the first impression as the total was affected by some commodities that weigh heavy. For example, after excluding the base metals and articles of base metals, the quantity exported of other products would have increased by 8.3%. And if we also exclude as an example each of the chemical products and the mineral products that witnessed an increase in their quantities exported, and also the vegetable products whose exports declined, the quantities exported of all other commodities would have increased by 4.5%.

In conclusion, exports of goods recorded in 2017 a slight decrease in terms of value under the influence of the decline in the value of the item of precious stones and precious metals exports. This decline turns into a slight increase if we exclude this item. Exports of goods did not exceed for the third year in a row the threshold of the three billion USD, given that their value exceeded USD 4 billion yearly during 2010-2012, and is decreasing continuously compared to the GDP.

EXPORTS OF GOODS

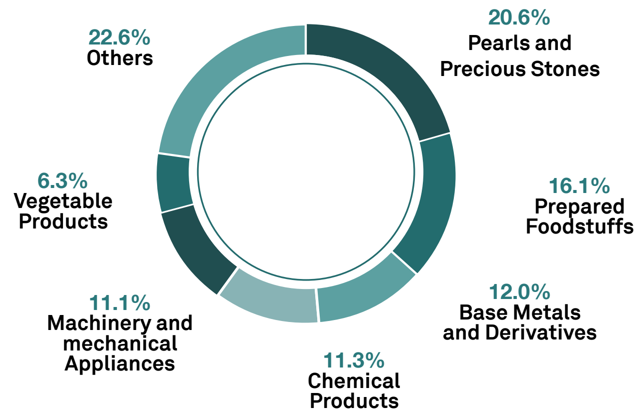
	2015	2016	2017
Value – USD million	2,952	2,977	2,844
Change (%)		+0,8	-4,5
Quantities – Thousand tons	1,941	1,659	1,937
Change (%)		-14,5	+16,8

Source: Customs Higher Council.

12 Exports to the Arab countries increased by 7.7% in 2017 after declining by 18.7% in 2016. The quantities exported to these countries increased by 6.9% after declining by 17.9% in each of the respective years.

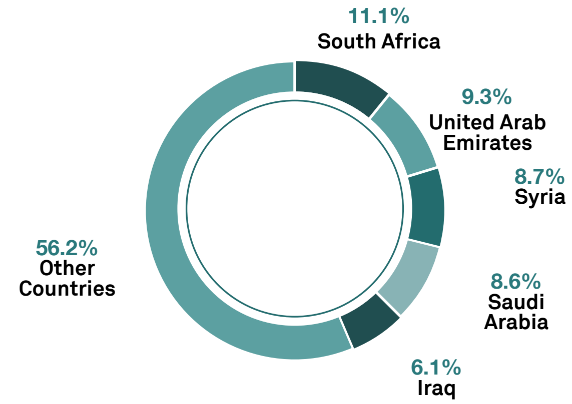
The two graphs below highlight the most important Lebanese exported goods and the most important countries that Lebanon exported to in 2017.

MAIN EXPORTED PRODUCTS IN % OF TOTAL IN 2017



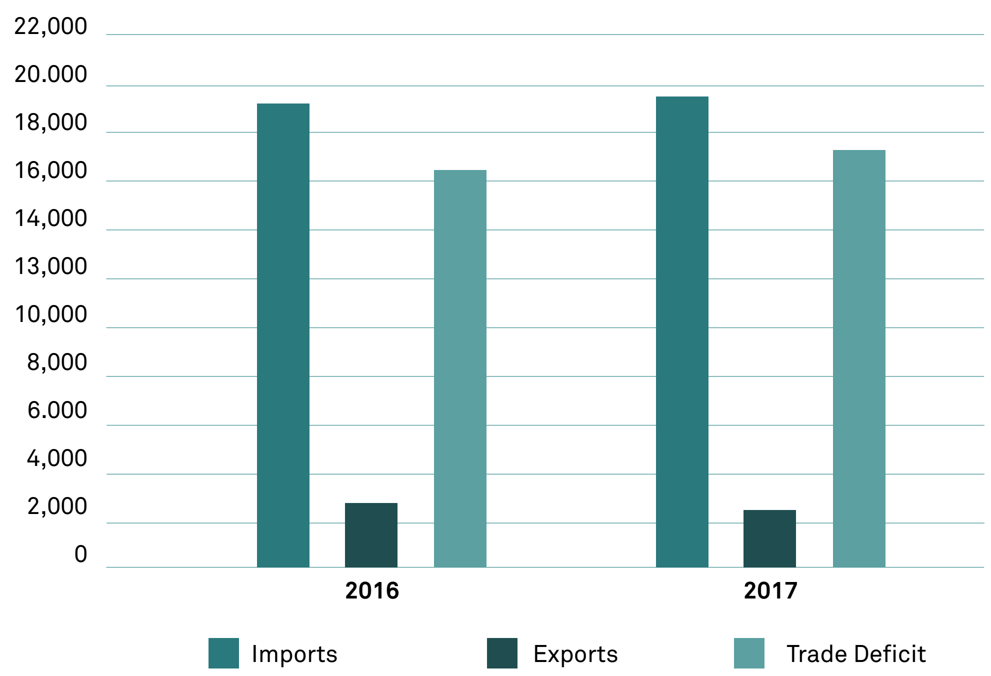
Source: Customs Higher Council.

EXPORT BY COUNTRIES OF DESTINATION IN % OF TOTAL IN 2017



Source: Customs Higher Council.

LEBANON FOREIGN TRADE
MILLION USD



VI- BANKS AND THE FINANCING OF THE ECONOMY

6-1

Despite the work environment that is full of challenges, and the weak economic activity and the capital inflows to the country, total assets/liabilities of the commercial banks operating in Lebanon increased by 7.6% in 2017 against 9.9% in the previous year. Given that the growth of these assets was not primarily and as usual the result of the growth in the deposits of the resident and non-resident private sector, which is nurtured by capital inflows and the activity of lending to the economy, but it resulted also primarily from the growth in other liabilities which multiplied as a result of the financial operations that the BDL implemented in cooperation with banks. The contribution of the outside factor, or capital inflows, was weak in 2017 due to the overall unstable condition, whereas the contribution of the internal factor alongside the public sector was moderate as the state did not rely on bank financing outside the framework of renewing maturities and the weak investment spending, with the contribution of the private sector remaining acceptable while below what could be achieved in normal circumstances. This reality imposed reinforcing the deposits and liquidity at the BDL, and thus protecting monetary stability.

6-2

At the end of 2017, the total consolidated balance-sheet of commercial banks operating in Lebanon reached USD 219.9 billion, increasing annually by USD 15.6 billion and 7.6% as we previously mentioned (an increase of USD 18.3 billion and 9.9% in the previous year). The realized increase in 2017 was distributed over the deposit base (41.9% of resource increase compared to 62.7% in 2016), capital accounts (5.7% from the additional resources compared to 8.6%), and other resources (44.6% of additional resources compared to 27.6%), which usually include interbank operations. This last item increased in 2016 and 2017 due to the financial operations and incentives that the BDL conducted in coordination with banks which varied by nature and size. At the request of the monetary authorities, banks will work on providing the requirements in LBP which are tied to the new financial international standards and their implications on capitalization and general provisions.

6-3

The deposit base in the consolidated balance sheet of commercial banks operating in Lebanon (excluding deposits in specialized banks and the off-balance fiduciary deposits) reached USD 173 billion at the end of 2017, registering an annual increase of 3.9% compared to a higher increase of 7.4% in 2016. The largest part of the increase in 2016 is attributed to the exceptional financial measures that caused attracting new foreign currency deposits. Whereas in 2017, the financial measures led to an increase in the size of unclassified liabilities. It is to mention that the deposits' growth in 2017 was affected to a certain extent by the resignation of the Prime Minister on 4 November as these deposits declined necessitating banks, in cooperation with the monetary authorities, to modify the structure of interest rates increasing them to alleviate the pressure that unexpectedly happened on the national currency and in order to preserve monetary stability.

6-4

The capital base increased by an amount of USD 885 million in 2017, or by 4.9% compared to an increase of 9.4% in 2016. Capital accounts represented 8.7% of total assets and close to 15% as solvency ratio based on Basel 3 at the end of 2017. This level is considered good by international standards as it complies with the level of various risks banks are exposed to in their work. Banks attempt to reinforce their capitalization to conform to the Lebanese and international requirements concerning Basel 3 and to constitute provisions and achieve what is demanded as per IFRS 9. The Basel 3 accord that Lebanon adopts is strict in ratios and periods with what they entail in requirements in capital and IFRS 9, in a period witnessing a decline in the government solvency, an increase in the risks of lending the economy, the worsening of foreign trade deficits in goods and services, and the thinning of capital flows to the country. Banks strengthen capital through rollover of profits or through attracting new investors to expand their work and serve their clients and to fulfill their commitments towards their depositors and shareholders, and reinforce confidence in their work, and thus in the whole banking sector. Continuing to finance the economy through its private and public sectors and support the reserves of the BDL, requires a permanent strengthening of capital accounts, reserves and provisions, and this is only possible through effective profits and new capital investment attracted by high profits. It is to mention that starting from the beginning of 2018, banks have started adopting IFRS 9 based on the basic circular of BDL no.143. The BDL issued as well basic circular no. 145 concerning the Liquidity Coverage Ratio (LCR) in conformity with the standard issued by the International Basel Committee.

6-5

The Lebanese banking sector remains the main financier of the private sector in light of the weakness of the stock and bond markets, as evidenced by the percent of loans to this sector that constituted around 113% of GDP at the end of 2017. Loans that banks provide to the private sector exceeded with the end of 2017 the amount of USD 60 billion, including loans to the non-residents mostly Lebanese businessmen. The data show that these loans are made to individuals and households and institutions from all regions with their distribution reflecting that of economic activity. Knowing that the trend of growth of loans to the private sector has started declining in the last years. The BDL adopted initiatives to provide the subsidized loans, to support the economy and reinforce financial inclusion. The incentivizing measures and circulars adopted by the BDL since 2009, coupled with the facilities relying on the required reserves, contribute to encouraging borrowing in LBP and achieving economic growth. The BDL has placed through the stimulus package, until the preparation of this report, around USD 5.2 billion at the disposal of banks at 1% interest so that they can continue to lend institutions and households through this new mechanism after the depletion of the required reserves mechanism, given that banks alone carry the credit risk. It is worth mentioning that utilized credits benefiting from deductions from reserve requirements and those benefiting from deductions from banks liabilities subject to reserve requirements stopped in October 2017 based on the BDL circular no. 475. Based also on the BDL circular no. 331 amended by circular 419, banks provided until the end of August 2017 around USD 369 million to the knowledge economy, out of which USD 321 million were invested in start-up funds and USD 34 million in incubators and accelerators and USD 14 million were invested directly in the companies.

6-6

Claims on the public sector dropped by 8.0% in 2017 similar to their decline in 2016. This decrease was faced by an increase in bank deposits at the BDL. Despite that, banks remain the main financier of the public sector needs even if the financing size differs from one period to another taking into consideration the liquidity, risks and other matters. The share of bank financing to the public sector declined to around 14.5% from the total balance-sheet (17% at the end of 2016) and 18.5% of bank total deposits at the end of 2017 (20.9% at the end of 2016) in favor of the increase in the share of their deposits at the BDL that reached 47.0% and 59.8% at the end of 2017 (43.1% and 53.6% respectively at the end of 2016). It is to mention that the banking sector has the financing ability to accompany the public projects, including the projects of partnership between the public and private sectors, which may constitute a principal factor for the success of the economic policies laid-out by the government.

6-7

Efforts of banks concentrate yearly on developing the banking institutions through investment in qualified human resources and the techniques and working systems of modern banking, and the respect for the sound professional rules. To safeguard the public interest and the interest of bank clients, depositors, borrowers and investors, banks are committed to the international rules and standards within the Lebanese laws and rules, especially Law no. 44 and circular no 126 issued by the BDL, and this takes place through the mechanism set by the BDL and accepted by external parties, including the US Treasury.

6-8

The Association of banks in Lebanon makes moves mostly in the direction of the USA as the Lebanese economy is highly dollarized: 67% of its deposits are denominated in USD, and more than 70% of its loans and facilities are denominated in USD, in addition to the deposits of the sector at the BDL that are placed mostly with international banks. Adding to the reality of dollarization in the liabilities and assets of banks, is that banks finance primarily in USD the foreign trade of Lebanon, in its imports and exports, and the touristic activity in both directions, and other cross-border services. It remains that using the USD in financing Lebanese payments with international markets requires solid, organized and trustworthy corresponding relationships especially with US banks in New York.

6-9

Lebanon is also committed to the international standards on the exchange of tax information adopted by OECD to remain involved in the financial globalization and to prevent its inclusion on the list of non-cooperative countries or not signatories on preventing tax evasion. The Europeans did not place Lebanon on any list concerning the subject of the exchange of tax information. It has entered the period of voluntary exchange of information which will start in September 2018 based on Law no. 55 on tax information exchange issued in the appendix of the official gazette no. 51 on 27/10/2016. Banks have lately tried and still are through the Association to insist on the legislative and executive branches to undertake the necessary measures to reinforce this exchange and conduct some legislative amendments to protect the savings of Lebanese immigrants in their homeland and the income of the Lebanese abroad from any misuse of the mechanisms and the information exchanged which may subject them to questioning resulting from the lack of financial disclosure and tax evasion.