LEBANON ECONOMIC REPORT

IN ORDER TO SAFEGUARD LEBANON'S STABILITY AGAINST DISORDERLY SHOCKS

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- Economy growing slowly but avoiding recession

  The Lebanese economy started the year 2013 with an activity similar to the one observed since the onset of the Arab Spring which had undoubtedly adverse spillover effects on Lebanon in the realms of investment, tourism and foreign trade. But within the context of some mitigating factors as well, the Lebanese economy didn't fall into a recessionary trap, with economic growth slowing down but remaining positive on the overall. As a matter of fact, the average increase in the Central Bank coincident indicator by 4.0% in the first two months of 2013, after having contracted in the past year, confirms that the Lebanese economy managed to avoid recession, though activity remains weak.

- Outlook could benefit from possibility of political breakthrough

  If a breakthrough sees the light, would it be at the level of a formation of a government that instills confidence to the business community or at the level of agreeing on an electoral law governing parliamentary elections, or if the touristic sector witnesses a significant increase in the number of tourists relative to the previous year's low base, the Lebanese economy can achieve a real GDP growth well exceeding the 2% forecasted by the IMF for this year, benefiting from the current gap between actual output and potential output.

- Monetary situation remaining at ease, bolstered by strong BDL reserves

  Lebanon's monetary conditions witnessed during the first quarter of 2013 a balanced foreign exchange market activity, a significant expansion in the LP CDs portfolio held by commercial banks, and lower subscriptions in Treasury bills by the banking system. The rise in the Central Bank's foreign assets to a new record high of US$ 37.3 billion by end-April 2013 is an additional proof of the stability of the foreign exchange market that witnessed this year more conversions to the Lebanese Pound than conversions to foreign currencies. At a level of foreign assets covering 85% of LP Money supply and 20 months of imports, the Central Bank is in an even better position to maintain the stability in its exchange market.

- Moderate banking growth performances along with sound financial standing

  Lebanon's banking sector witnessed moderate activity growth so far this year, amid an overall tough operating environment characterized by slow domestic economic activity momentum and difficult conditions across neighboring countries. Measured by the aggregated domestic assets of banks operating in Lebanon, banking sector activity progressed by 2.3% in the first quarter of 2013 to reach US$ 155.4 billion at end-March 2013. Banks maintained a solid financial standing, with a doubtful loan ratio of 3.5% of total loans, loan loss provisions accounting for 75.6% of total doubtful loans and a Basle II capital adequacy ratio of 11.6%, along with elevated primary liquidity at almost half the level of customer deposits.

- Mixed price movements across Lebanese capital markets

  The Eurobond market saw price declines during the first quarter of 2013 with spreads gradually reaching their cheapest level for the year, in the absence of favorable local political developments that may lift investor sentiment and spur activity. In parallel, the Beirut Stock Exchange saw small price rises during the first quarter of 2013 as some investors found a buying opportunity in Lebanese stocks despite prevailing political uncertainties mainly driven by attractive market pricing ratios and high yielding dividends distribution.

- Fiscal concerns growing among top macro challenges

  After Lebanon has witnessed an improvement in its debt and deficit ratios in the second half of the past decade, such ratios are back on the rise, with the debt ratio approximating the threshold of 140% and the deficit ratio approaching the 10% level. As such, it is important to note that within the context of the current situation in Lebanon and the region, and as all eyes are centered on public finance issues around the World, Lebanese authorities should avoid costly policies that add pressures on the State and weaken the ability of the domestic economy to confront domestic and external shocks at large.

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In the first quarter of 2013, the Lebanese economy continued to report a net activity slowdown amidst the sluggishness of private investment and the relative resilience of private consumption as witnessed by most real sector indicators. Within this context, and in its new World Economic Outlook issued mid-April, the IMF forecasts real growth of 2% in 2013, slightly up from a revised estimate of 1.5% for 2012. Although remaining relatively modest, economic growth in 2013 could be supported by a relative improvement in touristic activity from the low 2012 base, the spending of the accumulated Syrian refugees and the BDL stimulus package for bank loans.

At the level of domestic growth drivers, the sustained sound growth of private consumption is somehow supporting domestic spending at large. But while consumption continues to report a "relative" resilience, a flight from quality was reported within the economy, with declining spending on luxury items and growing spending on mass consumption products supported by the additional spending on behalf of Syrian refugees. Also, a wait-and-see attitude governing investors amidst persisting regional uncertainties continues to delay major investment decisions.

An examination of external growth drivers shows that these continue to be adversely impacted by the regional turmoil. Exports rose by a mere 3.2% in the first quarter of 2013, driven by maritime exports, as land exports continued to contract amidst the security escalation in Syria. FDI has been the most affected among external growth drivers within the context of investor cautiousness related to regional uncertainties. Touristic receipts have been on a net decline as well. Following contractions of 23.7% in 2011 and 17.5% in 2012, the number of tourists reported a further contraction of 12.5% in the first quarter of 2013 though the forthcoming summer season could be more promising. In parallel, the balance of payments recorded a small deficit of US$ 62 million in the first quarter of 2013, after relatively large deficits over the past two years.

With respect to sectoral performances, the in-depth analysis of the different sectors of the economy suggests they are performing unevenly, with some outperforming and others underperforming the overall economy. The defensive sectors are continuing to be F&B retail, pharmaceuticals, energy and education services while vulnerable sectors are building materials, cement, contracting, hotels and restaurants, media and communications. Sectors like agriculture, textiles and clothing, real estate, vehicles, insurance, transportation and health have been performing in line with the overall economy.

At the monetary level, stability continues to prevail at the level of prices and exchange markets. Over the first quarter of the year, inflation maintained a moderate average of 5.5% on an annual basis. The foreign exchange market witnessed net conversions from foreign currencies to Lebanese Pounds, while the Central Bank has been able to place its sovereign eurobond holdings with banks. Accordingly, BDL was able to improve the quality of its foreign currency reserves after having gradually raised the level of its reserves. At a level of foreign assets covering 85% of LP Money supply and 20 months of imports, the Central Bank is in an even better position to maintain the stability in the exchange market at large.

At the banking level, the economic slowdown was coupled with a slight contraction of inflows towards the home economy. The first quarter of 2013 reported a relative standstill in banking activity growth when compared to last year's corresponding period. Asset growth dropped from US$ 4.2 billion to US$ 3.6 billion, but deposit growth rose from US$ 2.5 billion to US$ 3.1 billion. Banks operating conditions continue to be tough, characterized by pressures on interest margins and fee income in addition to considerable provisioning requirements, exerting further pressures on banks bottom lines.

At the capital markets level, the first quarter reported tiny evolutions in equity and fixed income markets. The stock market reported a 1.4% increase in its price index within the context of attractive valuation ratios (P/E of 7.4x and P/NAV of 1.1x) but in a market increasingly lacking liquidity and efficiency. The annualized trading value to market capitalization registered a low 1.5% level, the lowest ratio reported in recent years. At the level of fixed income markets, the 5-year CDS spread, reflecting market perception of risks, has contracted by 23 basis points over the first quarter of the year.

The detailed developments in the real sector, external sector, public sector and financial sector will be analyzed thereafter. The concluding remarks are given to the 2013 growth outlook and stability challenges looking forward.

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture and Industry

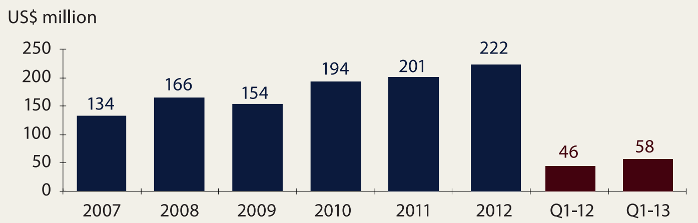
Lackluster domestic activity characterizing primary and secondary sectors

The activity of the primary and secondary sectors extended their sluggish performance in the first quarter of the year as internally, demand remained more or less contained while exports posted an increase mainly on account of shortages in the Syrian market. As a matter of fact, domestic demand was more or less sluggish due to a weaker economic activity while the foreign one increased, supported by demand from regional markets.

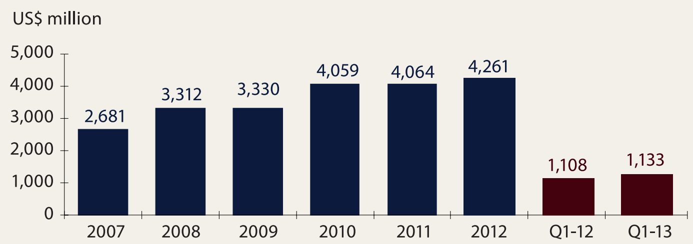
In details, the rise in agricultural exports accelerated from 4.5% year-on-year in the first quarter of 2012 to 26.1% year-on-year in the same period of this year. They totaled US$ 58 million in the first three months of 2013, almost 28% of which were destined to Syria. Noteworthy is that agricultural exports to Syria had already risen by 13.1% in 2012 following a decline of 6.3% in 2011. With regards to Jordan, another important market for Lebanon's agricultural products (circa 10% of agricultural exports), Lebanon found a way to bypass the Syrian routes by exporting through the sea to the Aqaba Port, despite the higher costs handled by the government. Indeed, a truck ferry route to Jordan was launched days after Lebanon's major transit route through Syria came to a complete halt due to adverse security conditions. Exports of agricultural products to the Gulf, nearly 20% of the total, were mostly enhanced by the fact that these countries were seeking to counter the shortfall of such goods usually imported from Syria. On the internal front, no major change was seen as the sector's activity was still contained on account of the adverse economic conditions. While imports of agricultural products did post an increase of 8.8% year-on-year in the first quarter of 2013, this stemmed from a low base as during the corresponding period of 2012, they had declined by 9.1%. In parallel, the number of Kafalat guarantees posted a decline of 40.2% in the first quarter of 2013 along with a hesitancy to initiate new projects related to agriculture.

With regards to the industrial sector, it followed almost the same path as that of the agricultural sector, with however a notable development at the level of the energy sub-sector. Effectively, Lebanon's energy exploration efforts are gathering pace. Lately, a group of 46 firms have qualified to bid on a first round of licenses to explore Lebanese offshore gas fields, with 12 qualified to bid as operators. By February 2014, exploration and production licenses for the 10 plots ranging in size from 1,259 to 2,374 sq km will be awarded. Yet, on the other sides of the sector, no significant change was seen on the internal front as well as the external one. Internally, industrial imports were down by 9.1% year-on-year in the first quarter of 2013 and the number of Kafalat guarantees extended to the sector was also lower by 46.7% over the same period, thus reflecting the slower activity and the contained appetite to initiate activity. Externally, industrial exports increased by 2.2% year-on-year with a significant portion directed to Syria. Indeed, apart from agricultural produce, Syria imported machinery, electricity generators, chocolate, sugar, tissues and towels.

AGRICULTURAL EXPORTS



INDUSTRIAL EXPORTS



1.1.2. Construction

Realty markets on a slowdown but not under pressure

A combination of a wait-and-see mood, weaker tourism activity and a sluggish economic growth meant that Lebanon's property markets have not renewed with the substantial growth seen during previous years. When looking at the demand components of the real estate sector, it is that of Arabs and non-resident Lebanese that is extending its slowdown so far this year within the context of stagnant investments. Indeed, demand remains mostly tied to local inhabitants and mainly focused on the residential segment without overruling relatively good activity within retail. It is worth highlighting that the 2006-2010 period was a period of rapid growth, and consequently, the market seems to be taking a breather and absorbing the drastic price hikes witnessed during such years. The prevailing environment is not actually generating a real estate crisis, as buyers are still purchasing at 2010 prices and even at prices slightly higher.

A look at the performance of property markets during the first quarter of the year shows that they are extending their slowdown which had started at the beginning of 2011. The number of property sales declined by 18.9% year-on-year to reach a total of 13,619 operations during the first quarter of 2013. In parallel, sales to foreigners are not yet showing signs of recovery as they sustained their downward trend and edged down by 32.6% year-on-year from the relatively low base seen in the first quarter of 2012, in line with the declining tourism activity, a wait-and-see attitude from investors and relatively contained private demand. Indeed, foreigners, and more particularly those of Arab origin, are being somewhat hesitant to purchased properties in the local market, with demand mainly stemming from residents. Also noteworthy is that sales to foreigners have been slowing down within the context of an announcement issued by several GCC countries discouraging their nationals to visit Lebanon.

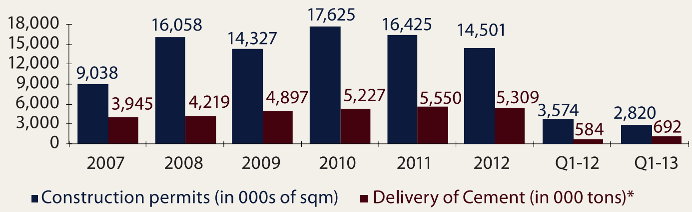
The decline in demand for property in Lebanon during the first quarter of this year was accompanied by a fall in the value of property sales transactions during the said period. It posted a decline of 22.5% year-on-year to attain a total of US$ 1,513 million in the first quarter of 2013. Such a downward movement was seen within most of the regions with the most significant decline seen in areas known for their higher prices: Beirut (-39.1%), Baabda (-25.2%), and Metn (-18.8%). In parallel, the breakdown of sales transactions by type shows that demand remains mainly shifted towards unbuilt areas which account for nearly 57% of the total while the built areas made up 43% of the total.

On the supply side, the construction sector has also adopted a slowing trend, along with the weaker demand. Figures released by the Order of Engineers in Beirut and Tripoli reveal that the area of newly issued construction permits weakened by 21.1% year-on-year in the first quarter of 2013. This suggests that contractors adopted a wait-and-see attitude when it comes to initiating new projects. A breakdown by region reveals that construction permits within Beirut, Mount Lebanon and South Lebanon declined by 52.6% year-on-year, 36.6% and 19.0% respectively, while other less expensive regions, which capture a lower share of permits, posted a net annual increase.

CONSTRUCTION

	2011	2012	Q1-12	Q1-13	Variation Q1/Q1	Variation 2012/2011
Value of property sales (in millions of US$)	8,841	8,926	1,953	1,513	-22.5%	1.0%
Number of property sales	82,984	74,569	16,784	13,619	-18.9%	-10.1%
o.w. Sales to foreigners	1,530	1,394	325	219	-32.6%	-8.9%
Average value per property sale (US$ 000)	107	123	116	111	-4.5%	15.5%
Property taxes (in millions of US$)	603	623	144	104	-28.1%	3.2%

EVOLUTION OF CONSTRUCTION INDICATORS



* 2-month figures for 2012 and 2013 cement deliveries

1.1.3. Trade and Services

Mixed performances in tertiary sector activity

The impact of a somewhat hectic local and regional environment has been felt on some components of the trade and services sector with some sustaining their contracting trend while others reported a mild increase. Indeed, tertiary activity initiated the year with a relative slowdown in consumption demand and a still sluggish investment environment, a fact mainly felt by the clearing activity and the tourism sector while the airport posted a rise in the number of passengers, yet at a comparatively slower pace as it remained boosted by the arrivals of Lebanese nationals. Activity within the Port of Beirut remains the main exception, benefitting from the diversion of merchandise from the relatively unsafe Syrian routes.

In details, maritime activity managed to reap the benefits of the weaker momentum seen with other trade routes as reflected by the activity of the Port of Beirut. The latter, which handles a good chunk of Lebanon's foreign trade services, was mostly on an upward path as reflected by the majority of indicators. Regardless of the decline in the number of transshipments (-8.6% year-on-year), the number of vessels using the port was up by 5.9% year-on-year and that of containers handled by the Port (excluding transshipments) increased by 22.1% year-on-year in the first quarter of 2013. In parallel, the tonnage of goods handled by the Port edged up by 17.5% year-on-year.

Activity within the airport also managed to remain positive though to a lesser extent as it remains mostly restricted to the arrivals of Lebanese nationals and that of Syrian refugees. This is reflected by the 11.4% year-on-year increase in the number of passengers (excluding the transiting ones) in the first quarter of 2013, as per the Directorate of Civil Aviation. Yet, departures accelerated at a faster pace than arrivals with the former rising by 16.3% year-on-year and the latter by 6.2% year-on-year during the first quarter of 2013. Conversely, the number of aircrafts at the airport was lower by 4.0% year-on-year in the aforesaid period of 2013.

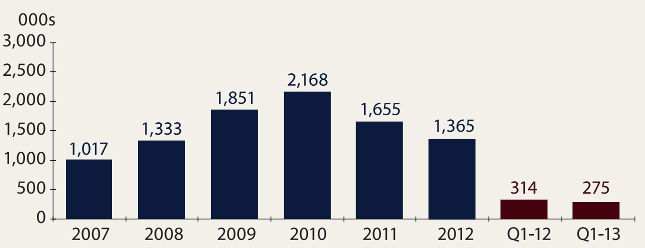
On a more negative note, the tourism sector is showing no improvement signs so far in 2013. The number of tourists reached its lowest level since the same period of 2008 and totaled 274,663 in the first quarter of 2013, constituting a decrease of 12.5% from the same period last year. The tourism sector is extending its losses mainly on account of lower arrivals of those of Arab origin which make up 36% of the total. Their number was down by 27.1% year-on-year, still due to a double factor linked to weaker land arrivals and governmental announcements dissuading them from visiting the country. Appetite from other parts of the world was also lower as arrivals from Oceania, Africa, and Asia declined by 4.1%, 2.8% and 16.0%, respectively. The slower activity at the level of the tourism sector as well as the airport reflected on the performance of the hospitality sector. In fact, the occupancy rate of five and four stars hotels within Beirut was at 56% in the first quarter of 2013, against 66% in the same period of 2012, as per Ernst & Young.

Concerning clearing activity, it revealed a relative slowdown in spending dynamics, mainly at the level related to the investment component in the country within the context of a comparatively contained economic growth. Accordingly, the value of cleared checks went down by 0.6% to US$ 17,266 million in the first quarter of 2013, bringing the velocity of money down by 8.1% over the period.

TRADE AND SERVICES

	2011	2012	Q1-12	Q1-13	Variation Q1/Q1	Variation 2012/2011
Number of ships at the port	2,167	2,125	493	522	5.9%	-1.9%
Number of containers at the port (in 000s)	585	635	138	168	22.1%	8.5%
Merchandise at the Port (in 000 tons)	6,677	7,226	1,634	1,921	17.5%	8.2%
Planes at the Airport	63,667	63,212	14,772	14,175	-4.0%	-0.7%
Number of passengers at the Airport (excluding transit)	5,596,274	5,913,305	1,226,727	1,366,586	11.4%	5.7%
Cleared checks (in millions of US$)	72,103	71,019	17,370	17,266	-0.6%	-1.5%

EVOLUTION OF THE NUMBER OF TOURISTS



1.2. EXTERNAL SECTOR

Slight contraction in trade deficit partly easing external constraints

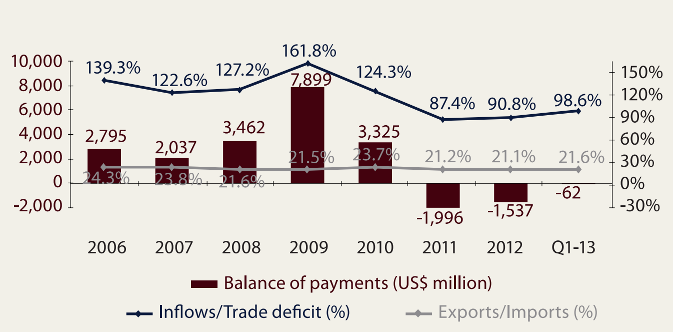
Lebanon's external constraints have comparatively contracted in the first quarter of 2013, down from the relatively high base seen in the corresponding period of 2012, during which the trade deficit had soared and had drastically impacted the balance of payments. Whereas the value of aggregate merchandise trading declined by 6.0% year-on-year, the goods' trade deficit contracted by a double-digit rate, slightly alleviating the burden on overall external accounts' performance.

Imports were lower by 7.7% year-on-year, moving to US$ 5.5 billion in the first quarter of 2013, as per the Higher Customs Council. Such a trend is partly tied to a quantity effect stemming from mineral imports which made up 38% of the total in the first three months of 2012, a share that dropped to circa 28% in the same period of 2013. In fact, imports of mineral products dropped by 33.8% year-on-year from a high 2012 base to attain US$ 1.5 billion in the first quarter of 2013. As to non-mineral imports, which account for 72% of the total, they were higher by 8.6% year-on-year to reach US$ 4.0 billion in the first quarter of 2013.

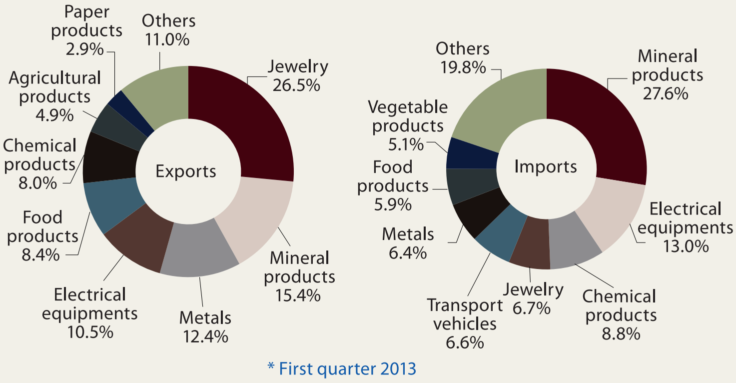
As to exports, they increased by 3.2% annually to attain US$ 1.2 billion in the first quarter of 2013. Such an upward trend is tied to the rise in the activity of the Port of Beirut which handles 37% of total exports as well as to that of the Ports of Tripoli and Sidon which handle a 12% share. Exports through the former were higher by 50% year-on-year and those through the latter by 94% and more than 100% year-on-year, respectively. This indeed offset the decline recorded at the level of exports through the Airport (34% of the total) and through the disturbed Syrian routes (17% of the total). Those through the former were lower by 2.0% year-on-year and those through the latter by 34% year-on-year during the first quarter of 2013. In parallel, a breakdown by country shows that exports to Syria recorded the most notable rise, moving from US$ 55 million in the first quarter of 2012 to US$ 229 million in the same period of this year. Exports destined to the conflict stricken country now account for 19% of the total in the first quarter of 2013 compared with 5% a year earlier. Such a trend managed to counterbalance the 26.3% year-on-year decline recorded by exports to the rest of Lebanon's main markets (Switzerland, Iraq, UAE, KSA, 25% of the total) as well as the 4.3% drop of those to the remainder of foreign markets (56% of the total).

The increase in exports, coupled with a decline in imports, resulted in an improvement in the export-to-import coverage ratio from 19% in the first quarter of 2012 to 22% in the corresponding quarter this year. Furthermore, Lebanon's trade deficit contracted by 10.4% year-on-year to reach a total of US$ 4.3 billion in the first quarter of 2013, reversing consecutive increases seen since the same period of 2009. Yet, Lebanon's external vulnerabilities are only partially on the mend as the balance of payments, though improving, remains in the negative territory. As a matter of fact, the balance of payments recorded a cumulative deficit of US$ 62.2 million in the first quarter, compared with a wider one of US$ 373.2 million in the corresponding period of 2012. The deficit in the balance of payments comes within the context of a net decline in Lebanon's financial inflows by 4.2% year-on-year to reach US$ 4.3 billion in the first quarter of 2013.

FOREIGN SECTOR INDICATORS



BREAKDOWN OF EXPORTS AND IMPORTS BY COMMODITY*



* First quarter 2013

1.3. PUBLIC SECTOR

Fiscal results portray growing challenges for public finances

Lebanon's fiscal accounts are back to the fore, as the repercussion of the previous year's growing imbalances along with the absence of reforms coupled with the ratified public sector wage scale have exacerbated an already critical issue for the country. The 2012 data recently published by the Ministry of Finance showed that public finances sank deeper into the negative territory to account for 9.5% of GDP, reversing three consecutive years of improvement to thus reach the highest level since 2008. In parallel, the primary balance, which excludes the debt service, has for the first time in six years recorded a deficit of US$ 109.9 million in 2012 compared with a surplus of US$ 1.7 billion in 2011.

In details, public expenditures were up by 14.1% to US$ 13.3 billion in 2012, 89% of which were allocated to current expenditures. Within the latter, the lion's share was allocated to the public sector's salaries adjustment which included the 2012 cost of living increase, encompassing retroactive payments that cover wage adjustment affects between February and December 2012. Accordingly, personnel costs, which make up 38% of current expenditures, were up 21.5% in 2012, with 66% allocated to salaries, wages and the related items. In parallel, transfers to the national electricity company were another boosting factor, increasing by 29.8% to make up 19% of current expenditures. Such a rise is linked to higher fuel oil and gasoil prices at the time the letters of credit were made, in addition to a LP 180 billion Treasury advance to cover the first of three payments for a contract between EDL and Turkish owner of electricity production barges, "Karpowership".

While expenditures reported a double-digit rise, the government experienced drastic difficulties in amassing revenues which were practically constant annually, rising only by 0.7% to reach US$ 9.4 billion, most of which coming from budget transactions. A revenue breakdown shows that the main source of revenues, namely taxes, were only up by 3.1%, driven by the miscellaneous ones and those from the customs which increased by 5.8% and 3.3% respectively, while VAT revenues were down by 0.7% in 2012. Non-tax revenues diminished by 5.1% mainly due to lower transfers from the Telecom surplus, Casino du Liban and Port of Beirut.

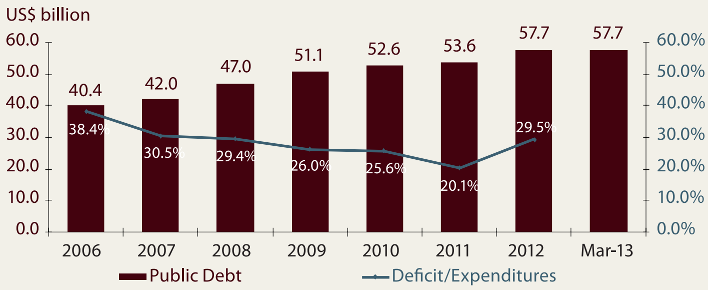
On the overall, Lebanon's fiscal deficit soared to its highest level so far to hit a total of US$ 3.9 billion in 2012, up by 67% from 2011, thus highlighting a problematic issue for the country which is in the process of considering multiple measures to develop its infrastructure. Yet, revenue raising measures remain a conflict for multiple parties within Lebanon which, in the absence of a government, bodes ill for fiscal accounts. This indeed puts pressure on Lebanon's indebtedness ratio which reached 139.5% in 2012, against 137.5% in 2011, reversing several years of net improvement.

PUBLIC SECTOR

in millions of US$

Deficit financing	Jan-12 Vol	Jan-13 Vol	Progression Vol
Deficit	176	18	-158
State creditor accounts	-176	-77	100
Other items	14	409	395
Uses=sources	**13**	**350**	**336**
LP	**26**	**269**	**243**
Treasury bills (banking system)	-39	-48	-9
Others	65	317	252
FX	**-13**	**80**	**93**
Sovereign eurobonds (including Paris II bonds)	-107	1	108
Others	94	79	-15

PUBLIC INDEBTEDNESS



1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Slower expansion in LP money supply coupled with a balanced exchange market activity

Lebanon's monetary conditions witnessed during the first quarter of 2013 a balanced foreign exchange market activity, a significant expansion in the LP CDs portfolio held by commercial banks, and lower subscriptions in Treasury bills by the banking system.

In details, the foreign exchange market saw a balance between demand and supply on the foreign market during the first quarter of the 2013. The decline in BDL's foreign assets by US$ 410 million to reach US$ 35.3 billion at end-March 2013, is partially driven by declines in the Central Bank's Eurobonds' portfolio. In fact, the Central Bank Governor announced in February 2013 that the Bank has sold US$ 2.5 billion of its Eurobonds portfolio to commercial banks. This came along news that the Central Bank has conducted a swap operation between its LP Treasury bills portfolio and its sovereign Eurobonds portfolio. It is actually important to mention that BDL's foreign assets covered 80.7% of LP money supply and 19.2 months of imports at end-March 2013, which spots light on the Central Bank's strong ability to defend the currency peg and meet demand for foreign currencies should any pressures arise.

A moderate growth in banks LP net claims on the public sector was reported in the first quarter of 2013. This resulted into an LP 893 billion expansion in LP Money Supply during the first quarter of 2013 (the equivalent of US$ 592 million) as compared to a much higher growth of LP 1,714 billion (the equivalent of US$ 1,137 million) during the corresponding period of 2012.

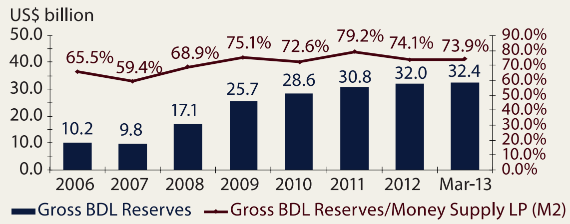
When adding foreign currency deposits, Money Supply in its broad sense (M3) grew by US$ 1,835 million or 1.8% during the first quarter of 2013. This money supply growth compares to a money creation of US$ 1,330 million in the first quarter (US$ 1,381 million during the corresponding period of 2012) that resulted from an increase of US$ 830 million in net bank lending to the private sector and from a US$ 669 million increase in the State's indebtedness towards the banking system (excluding valuation adjustments), within the context of a negative change in net foreign assets (excluding gold) of US$ 169 million. The difference between the growth in money supply and money creation amounting to US$ 505 million corresponds to a monetization of financial claims during the first quarter of 2013.

The Central Bank of Lebanon conducted swap operations between LP CDs maturing in 2013 and 2014 and new 7-year LP CDs with a yield of 7.60% (slightly higher than the 7.50% yield on the 7-year Tbs category), 8-year category (7.80%) and 10-year category (8.24%), while selling additional long-term CDs in exchange for cash. This resulted into a tangible expansion in the LP CDs portfolio held by commercial banks. In fact, the outstanding LP CDs portfolio rose from LP 23,073 billion at end-December 2012 to LP 31,195 billion at end-March 2013, up by LP 8,122 billion. In parallel, the aggregate banking system's subscriptions in Tbs (Banks + BDL) amounted to LP 3,488 billion during the first quarter of 2013 as compared to LP 4,959 billion during the corresponding period of 2012, noting that the former involved an intervention from the Central Bank of Lebanon on the primary Tbs market, as mirrored by a LP 1,513 billion growth in BDL's LP securities portfolio during the first quarter of 2013. Finally, the LP Treasury bills portfolio held by the public increased by LP 800 billion during the first quarter of 2013 to reach LP 8,682 billion at end-March 2013.

MONETARY SITUATION

Flows in US$ million	Q1-12 Vol	Q1-13 Vol	Progression Vol
Net foreign assets (excluding gold)	-339	-169	170
Net claims on the public sector (excluding valuation adjustments)	742	669	-73
Claims on the private sector	978	830	-148
Uses=Sources	**1,381**	**1,330**	**-51**
Money (M3)	1,713	1,835	122
Valuation adjustment and other items	-332	-505	-173

EXCHANGE MARKET INDICATORS



1.4.2. Banking Activity

Moderate performances in a relatively slow growth environment

Lebanon's banking sector witnessed moderate activity growth so far this year, amid an overall tough operating environment characterized by slow domestic economic activity momentum and difficult conditions across neighboring countries. Measured by the aggregated domestic assets of banks operating in Lebanon, banking sector activity progressed by 2.3% in the first quarter of 2013, moving from US$ 151.9 billion at end-December 2012 to US$ 155.4 billion at end-March 2013. The US$ 3.6 billion volume increase so far this year thus proved 14% lower than during the corresponding 2012 period, reflecting the slow growth environment and the still difficult operating conditions for Lebanese banks.

Total deposits continued to drive sector activity growth since the start of the year, and continued to account for the bulk of balance sheet funding, thus reflecting the banks' deposit-rich profile, with 82.4% of deposits to assets ratio as at end-March 2013. Customer deposits posted a 2.5% increase over the covered period to reach US$ 128.1 billion at end-March 2013, with the US$ 3.1 billion in additional funds proving 24% higher than during the year ago period.

The breakdown of deposits by currency shows that FX deposits grew by 3.1% in the first quarter to account for close to 80% of total deposit growth, with the remainder attributed to deposits in Lebanese Pounds which grew by the equivalent of US$ 634 million. Within this context, the deposit dollarization ratio slightly nudged up, moving from 64.8% at end-December 2012 to 65.2% at end-March 2013, yet still reflecting an overall balanced activity on the foreign exchange market and broad confidence in the Lebanese Pound.

Residents in Lebanon continued to be responsible for the majority of additional funds at Lebanese banks over the first quarter of 2013. As a matter of fact, resident deposits accounted for 60% of total deposit growth this year (+1.9%), while non-residents constituted the remaining 40% of total deposit growth (+5.1%).

Within the context of slower economic activity growth and the currently prevailing wait-and-see mood among lenders and borrowers, lending activity decelerated when compared to the year ago period. Bank lending actually progressed by a rather moderate 2.9% rate during the first quarter of this year to reach US$ 44.7 billion at end-March 2013. The US$ 1.3 billion in additional lending to the economy is almost 23% lower than what was extended in the year ago period.

The breakdown of loans reveals that the resident sector was once again the larger recipient of Lebanese banks' loans, with more than 80% of the total. Loans to residents managed to pull out a 2.7% year-to-date increase, while those to the non-resident sector only got 18% of total new loans, with banks somewhat less inclined to extend credit to the non-resident sector amidst the difficult conditions in the region. It is

BANKING ACTIVITY

in US$ million						Variation	
	2010	2011	2012	Q1-12	Q1-13	Q1/Q1	2012/2011
Var: Total assets	13,675	11,651	11,307	4,151	3,556	-14.3%	-3.0%
% change in assets	11.9%	9.0%	8.0%	3.0%	2.3%	-0.7%	-1.0%
Var: Total deposits	11,437	8,511	9,285	2,509	3,107	23.8%	9.1%
o.w. LP deposits	5,373	23	4,545	1,497	634	-57.6%	-
o.w. FC deposits	6,065	8,487	4,740	1,012	2,473	144.4%	-44.1%
% change in total deposits	11.9%	7.9%	8.0%	2.2%	2.5%	0.3%	0.1%
Var: Total credits	6,555	4,446	4,077	1,622	1,253	-22.7%	-8.3%
o.w. LP credits	2,351	1,618	1,216	338	238	-29.6%	-24.8%
o.w. FC credits	4,204	2,827	2,860	1,283	1,015	-20.9%	1.2%
% change in total credits	23.1%	12.7%	10.4%	4.1%	2.9%	-1.2%	-2.3%

worth mentioning that lending to the domestic private sector grew by US$ 1.0 billion in the first quarter of 2013, against US$ 0.9 billion in the corresponding period of 2012.

A look at banks' lending activity from a currency angle shows that almost 81% of new loans were extended in foreign currencies (+3.0%), and the remainder in local currency (+2.5%). Bank loans in Lebanese Pounds thus continue to cater to the needs of the domestic economy, partly favored by the BDL policies aiming to foster further lending in the local currency. Anyhow, it is worth noting that banks' financial flexibility remains particularly strong, with the loans-to-deposits ratio at a low 35%, and primary liquidity, i.e. bank placements with the Central Bank and banks abroad, accounting for close to half the deposits, thus providing room for substantial lending opportunities when conditions start to show sustained signs of improvement.

Banks also continued to extend credit to the sovereign so far this year, notably through subscribing to foreign currency debt issuances. While the foreign currency sovereign bond portfolio increased during the first quarter of this year to reach 1.17x total equity, the sovereign risk profile remains on the overall far more favorable than a few years ago when the sovereign exposure ratio as a percentage of total equity crossed the 2x threshold.

Banks' asset quality remained strong so far in 2013. According to the latest BDL figures covering the first two months of this year, the doubtful loans to total loans ratio stuck to its 3.5% level, which compares favorably to regional, emerging market and global averages. Also, bank provisioning continued to be adequate both in absolute and relative terms, with provisions accounting for 75.6% of total doubtful loans as at end-February 2013, slightly up from 74.7% at end-December 2012.

Along the same lines, Lebanese banks continue to boast satisfactory capitalization ratios. As a matter of fact, the total Basel II capital adequacy ratio stood at 11.6% at end-February 2013 according to the latest BDL figures, higher than the minimum requirement and thus providing banks with adequate buffers to withstand potential pressures on their capital base.

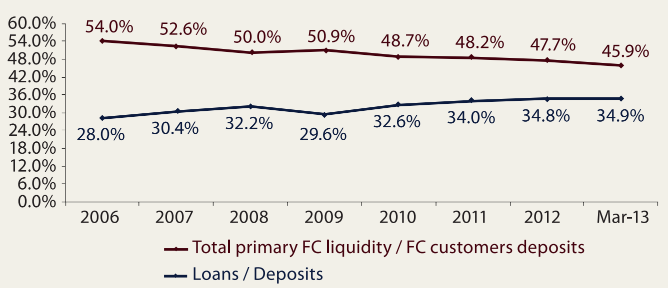
1.4.3. Equity and Bond Markets

Mixed price movements across domestic capital markets

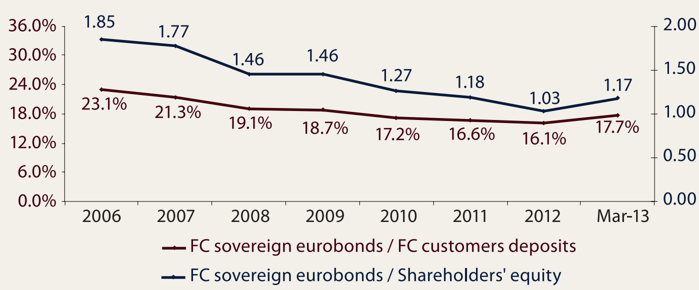
Lebanese capital markets saw mixed price movements during the first quarter of 2013, with the Eurobond market posting price declines amid relatively lower investors' buying interest, while the equity market reported small price rises, mainly driven by attractive market pricing ratios and high yielding dividends distribution.

The Eurobond market saw price declines during the first quarter of 2013 with spreads gradually reaching their cheapest level for the year, in the absence of favorable local political developments that could lift investor sentiment and spur activity. Local investors adopted a wait-and-see attitude, showing little interest in buying Lebanese debt papers despite the high level of commercial banks' foreign currency

BANKS LIQUIDITY STANDING



BANKS SOVEREIGN EXPOSURE



primary liquidity that has reached US$ 38.4 billion at end-March 2013, while foreign market players continued to underweight Lebanon in their portfolios, focusing their attention on the GCC debt papers amid lingering European debt concerns. Within this context, the average yield rose by 31 basis points to 4.67%, while the average spread widened by 19 basis points to 358 basis points. As to the cost of insuring debt, Lebanon's five-year CDS spreads contracted by 23 basis points during the first quarter of 2013 to reach 427 basis points at end-March 2013.

It is worth highlighting that the Central Bank of Lebanon sold in February 2013 circa US$ 2.5 billion of its sovereign Eurobonds to commercial banks. This was translated into a rise in the FC sovereign bonds-to-FC customer deposits ratio from 16.1% at end-December 2012 to 17.7% at end-March 2013. Also, the BDL launched towards the end of April a swap operation between LP Tbs and Eurobonds, noting that this followed a considerable growth in BDL's LP Tbs portfolio since year-end 2012.

Regarding new bond issues, Lebanon launched in April 2013 a US$ 600 million tap of its January 06, 2023 notes at 6.00% and a US$ 500 million tap of its November 29, 2027 bonds at 6.75%. The taps took the outstanding size of the 2023 notes to US$ 1.1 billion and the 2027 bonds to US$ 1.0 billion. Both issues attracted bids of US$ 1.4 billion. As such, the total Eurobonds portfolio reached at present circa US$ 21.1 billion versus US$ 19.7 billion at end-December 2012. Regarding credit ratings, Standard & Poor's affirmed in April 2013 the "B/B" long and short-term foreign and local currency sovereign credit ratings on Lebanon, while Moody's changed its outlook on Lebanon's government bond rating to "negative" from "stable".

In parallel, the Beirut Stock Exchange saw small price rises during the first quarter of 2013 as some investors found a buying opportunity in Lebanese stocks ahead of banking dividends distribution despite the prevailing local political uncertainties. In fact, the BSE traded at a weighted P/BV of 1.12x with some shares trading even below 1.00x, as compared to a quite higher P/BV ratio of 1.53x in the region. In addition, the BSE traded at a weighted P/E ratio of 7.4x at end-March 2013 as compared to a P/E of 12.7x in the MENA region. Added to attractive market pricing ratios, the BSE has luring dividend yields. In fact, the 2012 average dividend yield on banking stocks stood at 5.6%, which is higher than the 2012 average dividend yield for emerging markets (2.7%) and the average yield for Europe/Middle East/Africa (3.5%) according to the IMF, which should spot the light on the attractiveness of Lebanese stocks. As to market volatility, it is worth mentioning that the BSE volatility, measured by the standard deviation of share prices to the mean of prices, recorded a mere 0.8% during the first quarter of 2013, as compared to 1.3% in other emerging markets and 0.6% in other Arabian markets.

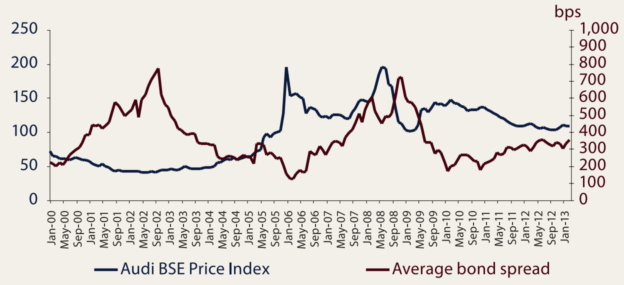
Given the small price rises and the new listing of BOB Preferred "I", the BSE market capitalization rose from US$ 9,982 million at end-2012 to US$ 10,355 million at end-March 2013, up by 3.7%. The total trading value amounted to US$ 39 million during the first quarter of 2013 as compared to US$ 91 million during the corresponding period of 2012. The total turnover ratio, measured by the annualized trading value to market capitalization, stood at 1.5% during the first quarter of 2013, noting that this is its lowest level in a decade, underlining the sluggish investment mood governing the BSE.

FINANCIAL SECTOR (NON-BANKS)

	2008	2009	2010	2011	2012	Mar-13
Beirut Stock Exchange						
Market capitalization (in millions of US$)	9,323	11,982	11,893	9,892	9,982	10,355
Total trading volume (in millions of US$)	1,659	943	820	513	408	39
Annual trading volume/Market capitalization	17.8%	7.9%	6.9%	5.2%	4.1%	1.5%
Price index	115.8	144.0	137.7	110.4	108.6	110.2
% change in index	-22.3%	27.3%	-4.4%	-19.8%	-1.6%	1.4%
P/E ratio*	8.97	10.19	8.82	6.92	7.02	7.40
P/NAV ratio*	1.47	1.51	1.43	1.12	1.10	1.12
Lebanese Eurobonds						
Total volume (in millions of US$)	17,178	17,704	17,736	18,954	19,654	19,955
Average yield	8.7%	5.3%	4.1%	4.4%	4.4%	4.7%
Average spread (bps)	727	290	182	321	339	358
Average life (in number of years)	4.6	4.6	4.7	5.5	5.6	5.8

* for large listed banks

CAPITAL MARKETS PERFORMANCE



2. CONCLUSION: THE URGENCY OF FOSTERING ECONOMIC STABILITY

The Lebanese economy started the year 2013 with an activity similar to the one observed since the onset of the Arab Spring which had undoubtedly adverse spillover effects on Lebanon in the realms of investment, tourism and foreign trade. But within the context of some mitigating factors as well, the Lebanese economy didn't fall into a recessionary trap, with economic growth slowing down but remaining positive on the overall. As a matter of fact, the average increase in the Central Bank coincident indicator by 4.0% in the first two months of 2013, after having contracted in the past year, confirms that the Lebanese economy managed to avoid recession though activity remains weak. Likewise, the Quantity theory of Money indicates low growth, with an annual increase in Money Supply by 7.0%, against a decline in the velocity of money by 8.1% and an average annual inflation of 5.5% in the first quarter of the year.

The 2% real growth forecasted by the IMF for Lebanon in 2013, following a revised estimate of 1.5% for 2012, is likely to materialize a case of a political standstill this year and in the assumption that the touristic sector doesn't undergo considerable amelioration during the summer months. But if a breakthrough sees the light, would it be at the level of a formation of a government that instills confidence to the business community or at the level of agreeing on an electoral law governing parliamentary elections, or if the touristic sector witnesses a significant increase in the number of tourists relative to the previous year's low base, the Lebanese economy can achieve a real growth well exceeding 2%, benefiting from the current gap between actual output and potential output.

We believe there are technically a number of factors that favor a growth improvement in 2013 relative to 2012, especially if the overall environment proves supportive. First, the incoming of Lebanese expatriates provides a partial support to growth, especially that their number outpaces the number of tourists foregone. Also, and while it is true that the Syrian refugees do not share the same spending attributes as tourists, their average length of stay is much longer that that of tourists, providing an important support to sectors like basic consumption, real estate rentals and education services. Second, the stimulus program adopted by the Central Bank through a lending package of US$ 1.3 billion, would have a positive effect on private demand, especially in its investment component that contracted last year, and thus ultimately on economic growth at large. It is worth noting that new lending to the resident private sector was 15% higher in the first quarter of 2013 than that of last year's corresponding period. Third, the wage increase which had a partial effect on consumption in 2012 (10 months for the private sector and 4 months for the public sector) is set to have a full effect in 2013. Fourth, tourism bottomed in 2012 as a result of the security drifts and kidnappings, so other things held constant, tourism in 2013 should be better in relative terms. Notwithstanding electoral spending in case parliamentary elections would be held this year, and which generally gives a relative boost to aggregate demand.

More importantly, despite the adverse spillover effects of the regional turmoil, the Lebanese economy is expected to maintain once again its overall stability, avoiding recessionary conditions in its real economy, avoiding unwarranted pressures on its currency's exchange rates and avoiding an outflow of capital from its well reputed financial sector. The rise in the Central Bank's foreign assets to a new record high of US$ 37.3 billion is an additional proof on the stability of the foreign exchange market that witnessed this year more conversions to the Lebanese Pound than conversions to foreign currencies. Likewise, the continuing growth in bank deposits by sound rates that exceed the borrowing needs of the economy in its private and public sector components, is an additional proof of the resilience that the Lebanese banking sector enjoys under an atypical operating environment.

What remains to be said is that stability is not equivalent to immunity. The relative financial and monetary stability that Lebanon witnessed under the cloudy conditions of the past couple of years does not mean that the economy is insulated from risks, especially that this period has witnessed a deterioration of the most important imbalance that the country suffers from and which is that of public finances. After Lebanon has witnessed an improvement in its debt and deficit ratios in the second half of the past decade, such ratios are back on the rise, with the debt ratio approximating the threshold of 140% and the deficit ratio approaching the 10% level. As such, it is important to note that within the context of the current situation in Lebanon and the region, and as all eyes are centered on public finance issues around the World, the Lebanese authorities should avoid costly policies that add pressures on the State and weaken the ability of the domestic economy to confront domestic and external shocks and contain their spillover effects with no disorderly market drifts at large.

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