Syria Economic Report

August
2008

THE CHALLENGE OF MAINTAINING A NON-OIL GROWTH MOMENTUM

- Syria witnessed in 2007 another year of solid economic activity, benefiting from the booming regional demand and ever-growing flow of petrodollars. This has translated into accrued liquidity at hand in the economy and large scale projects. Real GDP growth stood at 6.6% as per Central Bank preliminary figures, higher than the average of the previous five years, yet the International Monetary Fund (IMF) seems more conservative on Syria's performance, placing real growth at a lower 3.9%. Anyhow, growing economic activity, coupled with the global rise in oil prices and the surge in commodity and basic foodstuffs costs, led inflation to spike to a decade high of 14.3%, according to official sources, raising concerns among economic agents and calling for the monetary authorities to intervene in order to curb down pressures on price levels.
- The oil and gas sectors in Syria continued, in 2007, to weigh on economic growth at large. According to the IMF, the oil-GDP growth was -7.3% in 2007, down from -6.4% in 2006. Syria's crude oil production was around 394,000 barrels per day (bbl/d) in 2007, down from 421,000 bbl/d in 2006. The declining oil production, expected to maintain this downward trend, coupled with a growing consumption, is making Syria more and more dependent on energy imports. Syria has been working on developing new domestic energy resources and, at the same time, switching more to gas usage and resorting to imports from close by countries.
- The construction activity momentum went on in 2007, though some signs of slowdown in the real estate market started appearing in the second part of the year, after more than three years of buoyancy. Yet the favourable new laws and the expansionary construction projects should reduce supply bottlenecks and re-ignite interest in property. Overall, the sector's outlook seems to suggest that the boom has not busted, but what is happening can rather be a transitory stage for the market to re-adjust to new incentives and developments.
- Trade and services' performance in 2007 was generally favourable. Tourism did well in 2007 and continued in its expansionary trend. Other related sectors, such as transport and trade, were also undergoing changes and reported acceptable performance. Maritime transport indicators were favourable in 2007, within the context of the growth in tourism and, more importantly, the liberalization of trade and increased economic openness. Syria's two largest ports handled a total of 20 million tons in 2007, stable from a year earlier, as well as 563,000 containers, up by 10% since the previous year.
- Syria's external sector registered a vigorous performance in 2007 in terms of aggregate activity. According to data obtained from official authorities, the overall foreign trade volume stood at US$ 23.8 billion, registering a yearly increase of 23%. However, this was accompanied by a worsening in the country's terms-of-trade, as imports progressed at a faster pace than exports, leading the trade deficit to reach one of its record high levels in 2007 of US$ 604.1 million, compared to a surplus of US$ 860.6 million in 2006.
- The economic developments of 2007 and the reforms introduced by the Syrian authorities have left positive traces on fiscal performance. Fiscal performance in 2007 actually improved, with the overall fiscal deficit estimated at 4.6% of GDP last year, against a slightly higher 5.7% in 2006. Likewise, the non-oil fiscal deficit moved from 13.4% of GDP in 2006 to 10.9% in 2007. Syria's government debt stood at 49.2% of GDP according to the IMF, down from 51.3% in the previous year.
- The year 2007 proved to be another year of sound growth for Syria's banking sector, in line with the country's healthy economic performance. Banks have continued to develop, and all major banking aggregates have grown last year. The overall sector size, measured by total assets, grew by 13.0% year-on-year to SP 1,593.2 billion at year-end 2007. Total deposits of banks grew by a sound 14.9% in 2007 to reach SP 924.4 billion. An increasingly important growth driver in the sector was loans to the economy, recording a rate of 19.9% to reach SP 305.5 billion, notably higher than last year's sound 14.5% rate, suggesting that banks in Syria are increasingly acting as a financial intermediation vehicle, gathering liquidity and allocating it to those in need of activity funding.

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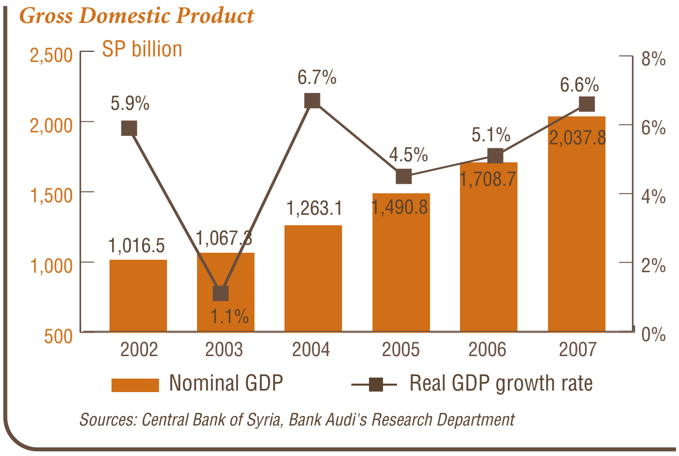
Bank Audi sal - Audi Saradar Group
Research Department
Banque Audi Plaza, Bab Idriss
Riad El Solh - Beirut - Lebanon
P.O.Box : 11 - 2560
Tel : (01) 994000
Telefax : (01) 985622
E-mail : research@banqueaudi.com

Bank Audi Syria s.a
Headquarters: Youssef Azmeh Square
Mouhafaza Building - Damascus
P.O.Box : 6228, Damascus - Syria
Tel : 963-11-2454868
Fax : 963-11-2248510
E-mail : contactus.syria@banqueaudi.com

Bank Audi sal
Audi Saradar Group



1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Oil Sector

The oil and gas sectors in Syria continued, in 2007, to weigh on economic growth at large. According to the IMF, the oil-GDP growth was -7.3% in 2007, down from -6.4% in 2006. Oil and gas exports receipts that accounted for 41% of total exports receipts in 2006 went down to 38% in 2007. Likewise, while oil used to account for the bulk of public revenues, it only represents around a fifth of government receipts today.

Syria's crude oil production, which is split between heavy and light grades, was around 394,000 barrels per day (bbl/d) in 2007, down from 421,000 bbl/d in 2006, according to Economist Intelligence Unit (EIU) estimates. The declining oil production, expected to maintain this downward trend, coupled with a growing consumption, is making Syria more and more dependent on energy imports. According to official sources, the depletion is around 20,000 bbl/d a year in the short-term, driving down output to an estimated 360,000 bbl/d by the end of 2008. Within this context, Syria has been working on developing new domestic energy resources and, at the same time, switching more to gas usage and using imports from close by countries.

Syria is trying to attract foreign investors for new exploration and production techniques such as enhanced oil recovery (EOR). In July 2007, results of newly inaugurated steam injection-enhanced oil recovery operations were announced, with a 16% improvement in recovery rates, as compared to 7% enhanced recovery using traditional EOR techniques.

At the same time, efforts are being made to increase refining capacity, in the hope of benefiting from oil transported from nearby rich-energy countries. Syria plans to overhaul its two existing state-owned refineries in Banias and Homs each with a capacity of 120,000 barrels per day, to process heavier crudes, including Iraqi oil, and replace output of fuel oil with lighter products and meet European standards for fuel imports. Syria's refineries produce a surplus of heavier products, including fuel oil, but fail to meet demand for lighter products, including distillates. In addition, three new refineries will be built to increase refining capacity by around 380,000 bbl/d by 2010-2011.

Syria's gas resources -estimated at 2.45 billion cubic meters of reserves remaining to be exploited- suffer from the same challenges as the oil sector, mainly the imminent shortage, undeveloped infrastructure and limited refining capacity, yet this sector seems to have a relatively more promising outlook than oil. Syria's gas production is estimated by the EIU at 5.3 billion cubic meters in 2007, down from 5.5 billion cubic meters in 2006. Output is all used domestically. However, as the country's power plants are all switching to gas, demand is expected to double in a few years time. Syria is planning to increase production to around 350 billion cubic feet (Bcf) by 2010, by bringing several new fields online with the help of foreign partners, as part of a strategy to substitute natural gas for oil in power generation and industrial use while freeing up as much oil as possible for export.

At the same time, gas imports should also get a boost, as the Arab Gas Pipeline (AGP) is completed. Indeed, Syria started purchasing gas from Egypt in July 2008. The section of the pipeline that is within the Syrian borders runs to the Rayan gas station near Homs, although gas is currently flowing only to Deir Ali. Eventually, the pipeline will be linked to the Turkish, Lebanese and Iraqi grids. The flow rate is expected to rise gradually to 2.5 million cubic meters of gas per day (cbm/day) and within nine years to 6 million cbm/day. Imports are predicted to rise to 77 Bcf by 2012. Gas processing will take place in the existing five gas processing plants, having a capacity of approximately 1.1 Bcf per day. Three new joint ventures with foreign firms are underway, raising the downstream gas processing by an estimated 500 million cubic feet per day.

To sum up, Syria's oil and gas sectors are challenged again in 2007 due to increasing demand, lower production, and thus higher dependency on energy imports and more vulnerability to the international price hikes. Authorities are making clear efforts in considering alternative energy sources, facilitating imports, and minimizing its costs. Looking forward, although Syria's oil sector has advantages based on its strategic location and prospective energy transit routes- being the only producer in the Eastern Mediterranean region, it is evident that it will not act as an economic driver for Syria anymore; hence the imminent need to channel efforts into other productive sectors that can push national development and hedge against energy downturns in the long-run.

1.1.2. Agriculture and Manufacturing

Agriculture is a vital sector for the Syrian economy, feeding a large population that is growing at a high 2.5% rate. The sector accounted for the largest share of domestic output (23%) in 2007, according to the State Planning Authority, while also employing a third of the labour force. However, for the second consecutive year, climate conditions hit Syria's 2007/2008 harvest.

The agriculture sector suffered again from a ten-month long drought, the worst the country has faced since a devastating drought in 1990-1991. The primary farming provinces received only some 25% of their average rainfall in 2007 and 2008. In particular, cereals, especially wheat, Syria's strategic and most important food crop, had lower yields due to irrigation. The inefficient irrigation methods, one of the key obstacles to agricultural development in Syria, are becoming a major risk that authorities are attempting to tackle through the modernization of irrigation systems.

In details, Syria's wheat crop was estimated to drop to 2 million tons this season, which is half of last year's and a seventeen-year low. This level is much lower than previous estimates of around 3 million tons, which were already well below last year's production of around 4 million tons. This downturn is significant for Syria, which is a major food commodities player in the Middle East and has food security as a cornerstone of its government agenda. In such cases, Syria resorts to its large wheat reserves that are not disclosed, but is expected to have been decreasing, since production was regularly below consumption levels during the last couple of years.

Another important crop in Syria, cotton, has also been registering lower yields and thus failed to meet its historical role as a primary cash-crop. In fact, the Ministry of Agriculture decided this year to reduce cotton-farmed land to meet only the needs of the domestic private and public sectors and the capacity of local yarns, estimated at 650 thousand tons. The Ministry targets around 700 thousand tons of seed cotton. The cotton farmed area declined from 220 thousand hectares to around 180 thousand hectares. This reduction will be coupled with an increase in cereals' cultivation, especially wheat, barley and corn, since Syria suffers from a shortage of animal feed driving it to import these crops at the very high prices of international markets.

Cotton and lint also feed into an important textile manufacturing sector which is the second export foreign receipt source, after oil. Textile exports are estimated at US$ 1.537 billion in 2007, according to the EIU, up from US$ 1.507 billion in 2006 (a 2% growth year-on-year). The government's goal is to increase production of cotton yarn and textiles and to increase exports of these products in lieu of cotton lint.

The state-owned textile firms, operating in the textile industry from spinning mills, to weaving, processing, manufacturing of wool and carpet, ready-made garments, hosiery and silk, are grouped under the General Organization of Textile Industries (GOTI). These firms are undergoing an overhaul to modernize production techniques and meet world competition. Most other manufacturing activities, other than those specialized in textile, are in sectors such as chemicals, food, metals and electronics, and are also grouped under state agencies, thus remaining, likewise, under government control, although authorities are introducing a number of economic reforms to move into a market-based economy and to provide a business-friendly environment for investors.

The industrial sector saw fundamental changes in 2007 with the launch of new projects and introduction of a great number of laws to boost production and counter impediments. Some 100 industrial projects are underway, and are worth SP 40.1 billion (US$ 8 billion), according to the State Planning Authority as reported in the media. The major projects in 2007 were in the auto industry, bottled water, and cement and construction material. To support this initiative, the State also encouraged industrial scientific research and held many forums and seminars on the subject. It also drafted a law to protect industrial start-ups to guarantee success of Syrian industries against international competition. Another law was also drafted on regulating industry, which would bring several crafts to the care of the trade chamber and facilitate licensing and benefiting from new industrial legislation.

For example, pharmaceutical manufacturing got a boost after the enactment of a recent law to facilitate the conduct of laboratory tests to develop generic medicines after they used to resort to other countries' labs. The law will add credibility to Syrian drugs after some four Syrian drug manufacturers had received a statement of international Good Manufacturing Practices (GMP), under a German sponsored programme. Syria hosts the largest number of drug manufacturers in the Arab world, with a total of 64 plants, including two state-owned. Syrian exports of pharmaceuticals stood at US$ 150 million in 2007, according to the secretary general of the Scientific Council for Pharmaceutical Industries, though the Arab Union of Pharmaceuticals estimates a higher volume of these exports in 2007 at US$ 210 million, making Syria the third largest in the Arab world. In all cases, these exports have been growing steadily by double digit rates in recent years.

Other sectors that saw developments in 2007 are cement and cars. With the political relations strengthening with Iran, the Syrian-Iranian Automobile Company set two new factories to produce the Iranian-designed Sham and Saba family sedans. Likewise, a cement plant, under a joint venture between an Iranian company and the Syrian National Cement Company, was established with an annual capacity of 1 million tons. The cement sector is, indeed, attracting local and foreign investors' attention with a market size of 7 million tons as estimated for 2007, but with a huge upside potential. Syria's six state-owned cement producers are not meeting the growing demand. This is why a number of foreign players are entering the market.

France-based Lafarge sa is setting up a greenfield cement plant under the name of the Syrian Cement Company (SCC). The total cost of the cement plant, to be built in Aleppo, Syria, is estimated to be around US$ 590 million. SCC aims at developing a production capacity of 2.9 million tons of cement per annum by the year 2010. Similarly, private cement company Raqqa, a Turkish holding, will begin production before end-2008, at an annual rate of 1 million tons to ultimately double this capacity by the following year. Other similar projects expected to follow include Al Badia Cement, by Al Muhaidib Holding of Saudi Arabia, and Italcementi. Meanwhile, Al Rajhi Group from Saudi Arabia is in the final stages of negotiations to contract with an international firm to build a plant with a capacity of 3.5 million tons in the region of Al Rheibeh, near Homs.

The above cases are only some examples of similar developments in other manufacturing sectors. It is clear that there are serious attempts to push industrialization in Syria. Efforts are being made to boost the private initiatives and liberalize many sectors, but competition remains very tough especially at the level of exports. Quality standards still need to be upgraded for exports to reach diverse international markets. Without such developments, the modernization of manufacturing will remain incomplete and its benefits would soon be eroded by the development of other emerging countries.

1.1.3. Construction and Real Estate

The construction activity momentum went on in 2007, though some signs of slowdown in the real estate market started to appear in the second part of the year, after more than three years of buoyancy.

Looking back at the factors that underlie the surge in property demand and that triggered a boom in the sector would explain this recent deceleration. The growing large population, the business visitors residing in high-end real estate, the focus on tourism and the upgrading of the related infrastructure are all basic elements propping up activity. More recently, it has been the regular flow of Iraqis, and the Lebanese that fled their country in 2006 that gave the major thrust. Real estate demand thus dwindled once these "visitors" left the country, after the war on Lebanon ended but more importantly once Iraqis' entry to Syria became restricted this year, requiring a visa.

Other reasons that could have contributed to the slowdown are related to the announcement of the imminent launch of a Syrian bourse and the issuance of laws promoting investments in other sectors, giving investors lucrative alternatives for money placements in Syria. It is also worth highlighting that the high prices reached in the past few years and that made Syria comparable to some developed countries also reduced the demand pace. Laws promoting mega real estate projects and attracting foreign developers gave hope of a possible downward price correction as the market expands, and consequently made some investors hold on until new opportunities arise.

In short, demand for property in the last few months of 2007 put on brakes, but prices were generally sticky and developers were not willing to significantly cut back, which led to a form of stagnation. As a matter of fact, prices for property in Syria have been spiralling, reporting high double digit growth rates, and even triple digit rates in the last couple of years. In addition to the demand factors listed previously, the price hikes of building materials, namely steel and oil, propped up property value.

The Syrian government has been working on alleviating price pressures, with laws allowing developers to directly import their own construction inputs. Ensuring the availability of materials has, indeed, been a priority for authorities, especially with new laws and incentives, such as the special regulatory authority established mid-2007 to organize and promote realty development, within the context of the government's tenth five-year plan targeting a huge SP 500 billion expansion of the housing property market. Cement production has been a primary focus as well, since output lagged behind production with a gap of around two million tons a year so far, in the hope that the new foreign entrants into this industry would bridge the shortage and reduce construction bottlenecks.

Developers of all sizes seem to be receptive to these incentives. In addition to the ongoing mega real estate projects, like the US$ 4 billion Emaar projects (Damascus Hills and the Eighth Gate) and the ongoing US$ 15 billion Syria Bonyan City project, the Ministry of Tourism offered, in April 2007, US$ 13 billion projects to develop touristic complexes on the Syrian coast in Lattakia, Palmyra and on the shores of Lake Assad and preselected ten companies among several large Gulf real estate developers bidding. Other smaller projects are likewise underway, as the US$ 300 million Cordoba Hills and the US$ 320 million Aref Investment financial district development.

In conclusion, although the real estate sector has undergone some form of a slowdown, the favourable new laws and the expansionary construction projects should reduce supply bottlenecks and re-ignite interest in property. Overall, the sector's outlook seems to suggest that the boom has not busted, but what is happening can rather be a transitory stage for the market to re-adjust to new incentives and developments.

1.1.4. Trade and Services

Trade and services' performance in 2007 was generally favourable, though less dynamic than in the previous year when the influx of Lebanese and Iraqis ignited economic activity. In particular, tourism did well in 2007 and continued in its expansionary trend. Other related sectors, such as transport and trade, were also undergoing changes and reported acceptable performance.

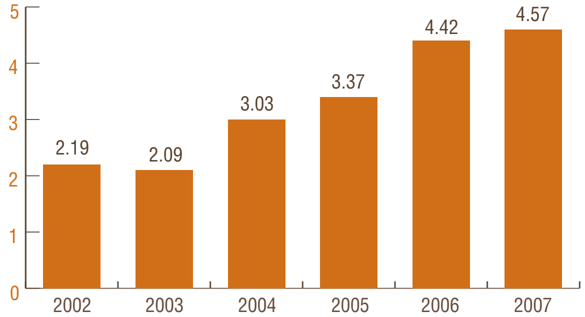
According to the Central Bureau of Statistics, the total number of tourists visiting Syria stood at 2.53 million in 2007, up from 2.45 million in 2006, a growth of around 3.4%. If Iraqis and Lebanese were included, the total number of tourists would stand at 4.57 million in 2007, up by 3.4% from 4.42 million in 2006. These growth rates seem mild compared to the double digit rates reported in 2006 and which brought the flow of tourists into Syria to another level. In fact, this progression came as a result of a jump in Arab tourists since 2005, mainly Lebanese, Iraqis and Jordan, with tourists of the first two nationalities accounting for 45% of the total.

Iraqi tourists alone reached 1.37 million in 2007, rising by a good 18.7% year-on-year but Lebanese tourists totalled 0.66 million, 18.9% less than the previous year after more than doubling in 2006 probably as a result of the war that hit their country during that summer. Jordanian tourists also increased by 3.7% to 761,578 tourists while those coming from the Gulf dropped by 2.1% to 577,390. As to other nationalities, Iranian tourists reported a strong growth exceeding 22% in 2007 and reached 304,956. European tourists totalled 0.24 million in 2007, up 7.3% year-on-year while American tourists remained very few, figuring 54,547, almost the same number as the previous year.

Accordingly, the number of hotel nights spent (excluding Iraqis and Lebanese) reached 23.1 million, up by 2.2% from 22.6 million in 2006. Tourism expenditures (excluding Iraqis and Lebanese) rose slightly to SP 61 billion in 2007, compared to SP 60.7 billion in 2006; a 1% growth. Iraqi tourists' spending alone reached SP 30.6 billion in 2007, rising by a good 18.7% year-on-year but Lebanese tourists' spending amounted to SP 7.5 billion, 18.9% less than the previous year after a 55.7% growth in 2006 as a result of the war that hit the country in the summer. Overall, when including all nationalities as well as visiting Syrian expatriates, the tourism industry generated some SP 142 billion in 2007, increasing by 2.6% year-on-year. This is equivalent to some US$ 3 billion, rising to more than US$ 4 billion when adding the revenues from internal or domestic tourism.

As such, the tourism sector accounted for almost 14.4% of GDP in 2007, employed 15.7% of the workforce, and generated 31.8% of foreign exchange receipts. However, the government aims to strengthen the role of tourism in the economy and, thus, plans to develop the touristic infrastructure and to attract investments in this area, as well as new visitors. According to official figures, some SP 195 billion were invested in 3,053 touristic establishments currently operating. In addition, SP 165 billion were placed in 350 projects, already in the pipeline and to be accomplished by 2010. These projects are only part of a detailed plan by the Ministry of Tourism for the next two years, reshaping the whole industry and introducing new measures for the first time, from marketing and promotion – such as an advertising campaign on international media promoting Syria's touristic sites, to human resources' skills development, upgrading quality of services and standards, creating new products, and luring investments.

Number of Tourist Arrivals to Syria (all nationalities except expatriates, in millions)



Sources: Central Bureau for Statistics - Syria, Bank Audi's Research Department

In line with these developments, the national carrier announced lately that it will add two new Airbus planes to its fleet before the end of 2008 with a plan to add 14 more aircrafts between 2010 and 2018. The company's small fleet has been the main impediment to its growth. Syrianair carried a total of 1.271 million passengers in 2007 according to the Minister of Transport, almost the same as the 1.252 million passengers of the previous year.

Maritime transport indicators, in contrast, were relatively more favourable in 2007, within the context of the growth in tourism and, more importantly, the liberalization of trade and increased economic openness. Syria's two largest ports, Lattakia and Tartous, handled a total of 20 million tons in 2007, stable from a year earlier, as well as 563,000 containers, up by 10% since the previous year. Tartous Port, the larger of the two in terms of bulk transport, handled 12.87 million tons and 28,744 containers. Lattakia Port, the larger of the two in terms of containers traffic, handled 535,000 containers and 7.79 million tons.

The two Syrian ports are expanding capacity to meet growing trade demand. In 2007, a new container terminal in Tartous helped increase container's traffic in Tartous to 18,275 containers in the first half of 2008, up 17% year-on-year by attracting two new international shipping lines. Currently, the number of shipping lines in Tartous Container Terminal stands at seven. A new law under discussion to permit transhipment at Syrian ports should further improve traffic. In 2008, Tartous Port is expected to record SP 3.1 billion in revenues, up from SP 2.95 billion in 2007.

1.2. EXTERNAL SECTOR

Syria's external sector registered a vigorous performance in 2007 in terms of aggregate activity. According to data obtained from official authorities, the overall foreign trade volume stood at US$ 23.8 billion, registering a yearly increase of 23%. However this advancement was more triggered by a progression in imports that surpassed the rise in exports, resulting in a significant deterioration in the trade balance, which reached one of its record high deficits in 2007 of US$ 604.1 million, compared to a surplus of US$ 860.6 million in 2006.

This swelling of the merchandise trade deficit stems from the fact that the annual growth of imports was more than two times that of exports, noting that the latter recorded a healthy double-digit growth rate of 14.6% to reach US$ 11.6 billion. Export growth was mostly driven by increased foreign demand for non-oil Syrian exports, as the value of these exports surged by a yearly 19.5% to reach US$ 7,144 million, and to a smaller extent, by an 8.7% rise in the value of crude oil and minerals' exports. The latter comes within the context of a contraction in Syria's oil output; however, escalating worldwide oil prices more than counterbalanced the drop in the volume of oil exports.

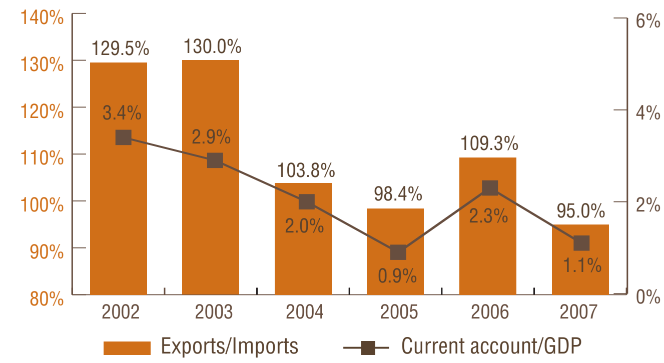
In parallel, imports soared upwards to reach US$ 12.2 billion, recording an annual increase of 31.9%, on account of increased trade liberalization measures and markets' opening to the private sector, not to mention the relatively improved domestic demand. Syria has been recently forced to liberalize aspects of its economic system in order to make up for oil revenue that has been slipping by around 10% a year. Liberalization measures include the reduction of transaction costs, the lowering of tariffs, a new publication of the tariff schedule and the unified negative list of imports, and Free Trade Agreements (FTA). Within the latter context, Syria is a member of the Greater Arab Free Trade Agreement (GAFTA) and the Arab Common Market, and is a signatory to FTAs with Jordan, Turkey, and more lately India. Also, Syria is at present negotiating an Association Agreement with the EU, and there have been recent talks of trade agreements or joint investments with Iraq, Iran, Malaysia, and Qatar.

The breakdown of exports shows that crude oil continues to represent the bulk export item, accounting for 38.3% of the total. Textile and footwear, which comprises raw cotton, yarns and garments, followed with 18.9% then live animals and vegetable production with 15.5%, machinery with 4.5%, food and beverages with 4.0%, chemicals with 3.6% and base metals with 2.3%. Imports, on the other hand, are mainly constituted of refined oil accounting for 34.9% of the total, followed by base metals with 14.7%, machinery with 9.8%, live animals and vegetables with 8.0%, transport equipment with 7.4%, chemicals with 5.6%, and food and beverages with 4.8%.

Italy was Syria's main export market with 21.8% of all the country's exports. France followed with 10.6% of total exports, then came Saudi Arabia with 9.8%, Iraq with 5.2%, the United Kingdom with 4.8%, Jordan with 4.2%, Egypt with 3.5%, and Lebanon with 3.0%. On the imports' side, Russia topped the list with 9.7%, followed by China with 7.9%, Italy with 6.8%, Ukraine with 5.8%, Saudi Arabia with 5.6%, Malta with 5.0%, South Korea with 4.5%, Egypt with 4.3% and Turkey with 3.9% of total imports.

In short, while Syria's merchandise trade balance came under immense pressure this year, its balance of services managed to pull off with a surplus due to the booming tourism sector, solid transit trade activity and stable remittances, and therefore diluted the commodity

Foreign Sector Indicators



Sources: Central Bank of Syria, Bank Audi's Research Department

trade deficit. Although the overall result was a growth in the balance of goods and services, this growth lagged behind previous records of the country. According to the latest "World Trade Indicators 2008" released by the World Bank, Syria ranked among the 20 countries with the lowest rates in real growth of trade of goods and services, which was estimated at 2.9% in 2007, down from an average growth of 3.3% in 2005-2006, and an average growth of 7.7% in the period extending between 2000 and 2004.

Finally, in order to improve its external sector activity, Syria needs to undertake measures targeted at bolstering its capital account by attracting capital investments, a trend which has already started two years ago but needs to be strengthened further. The World Bank noted that Syria's Doing Business rank is 137th (out of 178 countries) and its governance environment was less favorable than the MENA average or that of lower-middle income countries, the weakest governance indicator being regulatory quality. For this reason, the IMF recommended in its latest Article IV continuous efforts to improve the business climate and thus provide the private sector with increased incentives to invest. Moreover, while it commended the steady progress in trade liberalization, the IMF encouraged the authorities to further streamline the list of prohibited imports, abolish the system of industrial quotas, diminish the number of tariff bands, and eliminate non-tariff barriers. Last but not least, Syria should increasingly diversify its exports away from oil, by boosting agricultural and industrial exports, and thus gradually develop a more balanced exports structure, especially that the country's oil production is on the decline.

1.3. PUBLIC SECTOR

The economic developments of 2007 and the reforms introduced by the Syrian authorities have left positive traces on fiscal performance. However, in conjunction with such developments, the declining oil production, the subsidies' system, and the consumer prices' inflation that is weighing on the cost of living and driving social spending, are increasingly pressuring public spending. The government did not publish public finance actual results, yet a general assessment can be made using indicators available to the IMF. Fiscal performance in 2007 actually improved with the overall fiscal deficit estimated at 4.6% of GDP last year, against a slightly higher 5.7% in 2006. Likewise, the non-oil fiscal deficit moved from 13.4% of GDP to 10.9% in 2007.

Total government revenues are estimated to have progressed in absolute terms, but still stand at around 21.8% of GDP in 2007, versus 21.9% in 2006. Syria's revenues derive from three main sources: oil, state-owned entities' profits, and taxation. Oil receipts are dwindling, since the decline in production is outweighing the increasing prices. In contrast, Syria has been building up other sources of income as reflected by the non-oil revenues to non-oil GDP ratio slowly rising to 22.8% in 2006 and 2007, versus less than 18% five years ago.

State owned entities, mainly in telecommunication and financial services, boosted revenues, although according to the Minister of Finance, only half the amount budgeted for 2007 from the hundreds of operating state owned enterprises, was actually achieved. As to taxation, the Minister of Finance stated in the media that tax revenues reached SP 309 billion in 2007, with taxation from the public sector entities representing only 38% of the total, and the other 62% coming from Syrian individuals and corporations. It is worth mentioning that Syria has been lately introducing a number of laws to improve taxation, and more generally public administration, as it increasingly relies on this source of receipts, since customs and tariffs are being reduced to liberalize trade, not to mention the declining oil receipts. As a matter of fact, Syria will start imposing a 10% Value Added Tax, starting 2009.

On the other side, public expenditures reached 26.4% of GDP in 2007, down from 27.6% a year earlier and continuing a downward trend started since 2003. The main saving came from below-budget spending on capital investment. Syria still has an extensive system of price subsidies as well as a significant social assistance program. In May 2008, the government eliminated subsidies on gasoil, which accounts for more than half of Syria's consumption of petroleum products, in a move to reduce significantly its subsidies' bill. However, this was coupled with an announcement to raise 25% in salaries and pensions of all public sector employees.

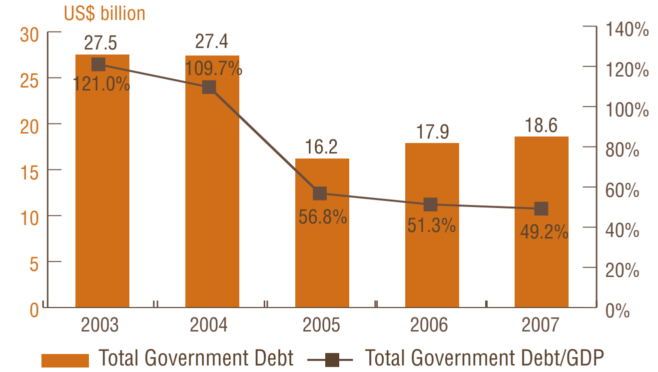
The budget for 2008 was set with the lowest spending growth in years, as a result of the significant contraction in revenues. Expenditures are

Selected Public Finance Indicators

	2002	2003	2004	2005	2006	2007	Var 03/02	Var 04/03	Var 05/04	Var 06/05	Var 07/06
Central government revenues/GDP	26.5%	28.8%	27.2%	24.0%	21.9%	21.8%	2.3%	-1.6%	-3.2%	-2.1%	-0.1%
Central government non-oil revenues/ non-oil GDP	17.9%	17.8%	20.3%	22.3%	22.8%	22.8%	-0.1%	2.5%	2.0%	0.5%	0.0%
Central government expenditures/GDP	28.5%	31.4%	31.4%	28.4%	27.6%	26.4%	2.9%	0.0%	-3.0%	-0.8%	-1.2%
Central government non-oil fiscal balance/non-oil GDP	-18.9%	-22.0%	-19.4%	-15.3%	-13.4%	-10.9%	-3.1%	2.6%	4.1%	1.9%	2.5%
Central government fiscal balance/GDP	-2.0%	-2.6%	-4.2%	-4.4%	-5.7%	-4.6%	-0.6%	-1.6%	-0.2%	-1.3%	1.1%

Sources: IMF, Bank Audi's Research Department planned at SP 600 billion, slightly higher (2%) than the SP 588 billion of the 2007 budget. Current expenditures are set to increase by 10% to SP 285 billion, while investment expenditures would fall by the same rate to SP 230 billion. Revenues should reach a total of SP 407 billion only, down 20% from SP 504 billion of 2007, as a result of a sharp reduction in revenues from oil proceeds, from SP 246 billion in the 2007 budget to less than half this amount in the 2008 budget or SP 100 billion.

Public Indebtedness



Sources: IMF, Bank Audi's Research Department

Syria's government debt stood at 49.2% of GDP according to the IMF, down from 51.3% the previous year. In absolute terms, total public debt is estimated at US$ 18.6 billion in 2007, with most of this debt being domestic. Syria has been paying off most of its external debt especially that related to the Soviet era. In contrast, concerns regarding the growing domestic debt, which has been, so far, in the form of direct borrowing from the Central Bank, are rising, especially as the budget deficits grow and as the government starts issuing Treasury bills in 2008 for the first time ever.

Looking forward, Syria's public finances, in the next couple of years, are expected to remain constrained by declining oil production, while the new taxation measures and administrative reforms should have a sizeable positive effect on the deficit. At the same time, social pressures are anticipated to intensify, having an adverse effect on spending. Overall, the fiscal prospects seem to be mixed, especially that other more impactful structural measures, such as privatization, that could bring about drastic changes to the fiscal situation, have been shunned away by authorities and replaced with other forms of public administration solutions to address the losses of the large number of government entities.

1.4. FINANCIAL SECTOR

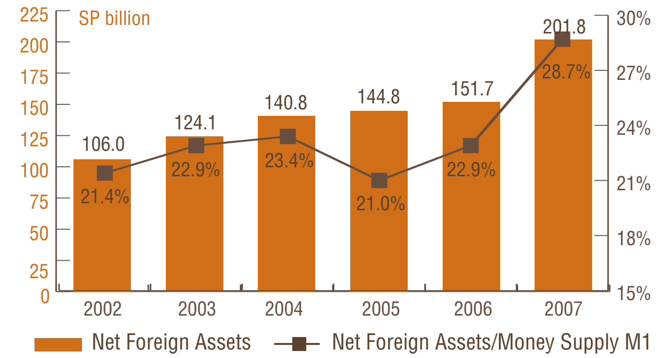
1.4.1. Monetary Situation

Syria's overall positive economic performance ensured a sound environment for the monetary sector. The enhanced liquidity in the region at large spurred by the oil boom and the ever-improving domestic economic activity have both led to a rise in capital inflows into the country, which on one hand allowed the Central Bank to boost its net foreign assets, and on the other hand favored a further hike in money supply. All this however added to external pressures on prices and propelled the local inflation rate to a decade high, calling for monetary authorities' intervention to curb down pressures on prices, mainly through the introduction of new reforms also aimed at modernizing the management of its monetary situation.

The large amount of projects and investments underway in Syria have blessed the economy with strong capital inflows and pushed the authorities' net foreign assets upwards by a substantial 33.0% year-on-year in 2007, from SP 151.7 billion at year-end 2006 to SP 201.8 billion at year-end 2007, as per Central Bank figures. This, coupled with a sharp rise in bank credits to both the public and private sectors, mostly led to a 12.4% increase in broad money supply. The latter indeed moved from SP 1,284.9 billion at year-end 2006 to SP 1,444.7 billion at year-end 2007.

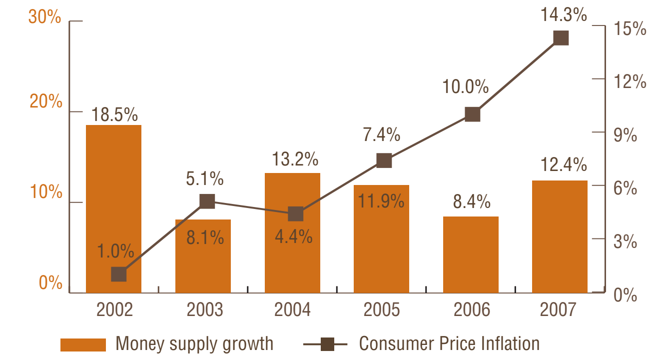
On the downside, a country with such buoyant economic activity and generating important money creation cannot but experience a hike in pressures on prices, all the more so external inflationary factors are kicking in as well. Not only have the price levels been affected by the surge in oil prices and hence transportation costs, but the adverse weather conditions around the world have not spared Syria from being hit by the global food price hikes. According to government sources, inflation in Syria has jumped from 10.0% in 2006 to nearly 14.3% in 2007, a new decade high. The source, quoted by the Economist Intelligence Unit, argued that food prices rose by 26% on average in 2007, with food-related spending of low and middle income families accounting for above half of their mean income.

Exchange Market Indicators



Sources: Central Bank of Syria, Bank Audi's Research Department

Money Supply and Inflation



Sources: Central Bank of Syria, Bank Audi's Research Department

Monetary Situation

Flows in SP million	2002	2003	2004	2005	2006	2007	Var 03/02	Var 04/03	Var 05/04	Var 06/05	Var 07/06
Net foreign assets (monetary system)	84,881	25,870	52,814	2,638	-21,730	-16,278	-69.5%	104.2%	-95.0%	-923.7%	-25.1%
Claims on public sector	-3,276	17,204	23,934	72,393	37,165	51,839	-625.2%	39.1%	202.5%	-48.7%	39.5%
Claims on private sector	5,198	25,468	38,366	74,759	32,222	50,774	390.0%	50.6%	94.9%	-56.9%	57.6%
Total	**86,803**	**68,542**	**115,114**	**149,790**	**47,657**	**86,335**	**-21.0%**	**67.9%**	**30.1%**	**-68.2%**	**81.2%**
Money supply (M2)	134,970	70,363	123,637	126,012	99,547	159,803	-47.9%	75.7%	1.9%	-21.0%	60.5%
Other items (net)	-48,167	-1,821	-8,523	23,778	-51,890	-73,468	-96.2%	368.0%	-379.0%	-318.2%	41.6%

Sources: Central Bank of Syria, Bank Audi's Research Department

Inflation is actually becoming a source of concern for economic agents, and led the government to implement a 25% increase in government salaries and pensions in May of this year, following its decision to cut back on fuel subsidies. Yet, these steps could actually defeat their purposes, especially that the government revised upwards the official procurement prices for several of Syria's main crops in April 2008, namely wheat, a main product of the local agriculture sector, barley, maize, cotton and sugar beet, mostly in an attempt to encourage higher production volumes and reduce smuggling, as farmers and traders have been enticed to take advantage of higher retail prices in neighboring countries. All this is adding pressures on prices, and could materialize in a high inflation rate this year as well.

Yet the authorities, thanks to a number of newly introduced reforms and innovations, are well placed to curb down such price pressures. The decision to link the local currency to the International Monetary Fund's Special Drawing Rights (SDRs, based on a weighted average of the values of the four leading world currencies, namely the US Dollar, the Euro, the Japanese Yen, and the Sterling Pound), in effect since the second part of 2007, has played the role of a stabilizer for the Syrian Pound, with the currency no longer tied to the ups-and-downs of a single foreign currency. This is believed to help Syria avert higher imported inflation henceforth, and even led to a healthy appreciation of the local currency against the US Dollar but also versus the basket of currencies. Further, the EIU reckons that the dominant position of public banks and the regulator's control over FX transactions, in spite of relaxed laws, should help authorities control the local currency's fluctuations and protect the value of the Syrian Pound.

Along the same lines, a decree on the issuance of Treasury securities has been approved, with such an instrument aimed at securing funding for the government. This should avoid the latter having to borrow from the Central Bank, and thus is expected to help manage liquidity in the economy, improve market practices (by creating a benchmark rate), and allow a better control of inflation, while providing the Central Bank with new and sophisticated monetary tools to manage the monetary situation and increase the efficiency of its monetary policy at large.

1.4.2. Banking Activity

The year 2007 proved to be another year of sound growth for Syria's banking sector, in line with the country's healthy economic performance. Banks have continued to develop, and all major banking aggregates have grown last year. The overall sector size, measured by total assets, grew by 13.0% year-on-year, from SP 1,410.4 billion at year-end 2006 to SP 1,593.2 billion at year-end 2007.

Banks operating in Syria have continued to attract inflows of capital into their accounts and thus total deposits continued to drive the sector's growth, accounting for nearly 60% of total sector size. Total deposits of banks grew by a sound 14.9% in 2007 to reach SP 924.4 billion. Foreign currency deposits slightly outpaced local currency deposits in growth last year, with the former growing by 18.2% and the latter by 14.1%. This pushed the deposit dollarization ratio slightly upwards to 20.0%, yet local currency deposits continue by far to account for the bulk of sector deposits. In parallel, total capital accounts of banks have witnessed a rise of 6.8% to a record high of SP 208.3 billion last year.

An increasingly important growth driver in the sector was loans to the economy. This category has unsurprisingly captured the top spot in terms of banking aggregate growth, recording a rate of 19.9% to reach SP 305.5 billion, notably higher than last year's sound 14.5% rate. This only proves that banks in Syria are more and more acting as a financial intermediation vehicle, gathering liquidity and allocating it to those in need of activity funding.

Yet, the growth in bank lending activity is reported to be somewhat narrow compared to the potential business volume. This is due to several conditions rendering Syria's borrowing environment a not-so-easy one, according to a recently released study by The Syria Report. First, there is a lack of benchmark interest rate setting, as banks are not remunerated in exchange of their deposits at the Central Bank, which hampers the long-term lending market locally. Second, most deposits are on a short-term basis, with local currency demand deposits alone accounting for 35% of the total, thus putting a time limit on loans extended by market players. Third, the capital base of private Syrian banks is relatively low compared to international benchmarks, which leads banks to resort to jointly provide financing facilities when its comes to large-scale projects.

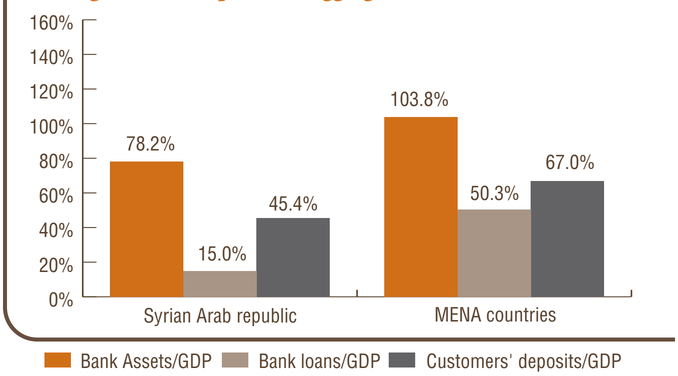
Also, weak internal lending practices in the still dominant public banks somehow undermine total lending activity growth. Anyhow, the Central Bank has implemented several measures than help offset such impediments and boost the lending activity growth. The regulator has for instance allowed local banks to provide loans locally to investors in foreign currencies, and authorized them to finance imports of free zones-based firms.

Overall, private banks are increasingly gaining ground on the local banking chessboard, though public ones still account for the bulk of activity, with more than 80% of total sector assets and loans, and 75% of deposits, in their hands. The private sector is increasingly enticed to conduct business with private banks and about a third of private sector deposits is held by non-government banks, a good percentage bearing in mind that government-related companies and bodies are constrained by law to work with public banks.

Banks have also achieved such a notable performance by improving their branching out across Syrian territory. The number of banks' branches is reported to have jumped from 321 branches at year-end 2006 to 348 branches at year-end 2007, noting that private sector banks' branches are accountable for practically all such expansion, and have witnessed a 53% jump in their number of branches serving a retail, commercial, and corporate clientele.

Such upbeat developments have enticed many newcomers into the

Banking Sector Comparative Aggregates (Year 2007)



Sources: Central Bank of Syria, Central Banks of MENA countries, IMF, Bank Audi's Research Department

Banking Activity

SP million	2002	2003	2004	2005	2006	2007	Var 03/02	Var 04/03	Var 05/04	Var 06/05	Var 07/06
Total assets	1,075,094	1,183,367	1,250,260	1,342,954	1,410,440	1,593,228	10.1%	5.7%	7.4%	5.0%	13.0%
% change in assets	10.5%	10.1%	5.7%	7.4%	5.0%	13.0%	-0.4%	-4.4%	1.8%	-2.4%	7.9%
Total deposits	571,834	618,199	669,661	733,253	804,457	924,447	8.1%	8.3%	9.5%	9.7%	14.9%
% change in deposits	21.7%	8.1%	8.3%	9.5%	9.7%	14.9%	-13.6%	0.2%	1.2%	0.2%	5.2%
Total loans to private sector	83,935	109,403	147,769	222,528	254,750	305,524	30.3%	35.1%	50.6%	14.5%	19.9%
% change in loans to private sector	6.6%	30.3%	35.1%	50.6%	14.5%	19.9%	23.7%	4.7%	15.5%	-36.1%	5.5%

Sources: Central Bank of Syria, Bank Audi's Research Department

Syrian banking scene. Three new private banks launched activities in 2007 while no less than nine others (all from the MENA region) are planning to do so in the near future. New entrants include Syria Gulf Bank, a joint venture between Bahraini, Kuwaiti, and Lebanese banks and financial institutions, and local investors. Cham Bank, a joint venture between Gulf firms and Syrian investors, launched activities in the summer of 2007 and is the country's first Islamic bank. The Syria International Islamic Bank opened to the public as well last year, and is owned by several Qatari financial institutions.

Out of nine banks expected to start activities soon in Syria, five are Islamic banks. Islamic banking is indeed an area expected to meet success in the country, thanks to an increasingly religious population, all the more so Islamic banks, unlike peers in neighboring countries, are penetrating the local market at the same time as conventional rivals are, which somehow prevents them from having to compete with a large number of already well established banks. Also, Islamic banks have benefited through regulation from a wider range of investment activities than their conventional peers, such as entering as partners in trade, industrial, and other ventures, according to The Syria Report, which should give them a slight edge that could compensate the still low public awareness about Islamic banking products at large in the country.

Yet, a clear and remarkable presence on the part of international banks still has to see the light. While it is argued that those players are specifically looking for majority stakes in local entities, the Central Bank governor recently announced its intention to go through with further liberalization of the sector, and raising the ownership limit on private banks in the country above the prevailing 49%, thus permitting foreign shareholders to retain a majority stake in local private banks. This is widely seen in banking and finance milieus as an essential incentive to foster further development in the sector, one that would help contribute further to boosting economic activity and propel Syria's banking industry to higher levels in years to come.

In parallel, the Damascus Stock Exchange (DSE), currently expected to launch trading activities by the end of 2008 or the start of 2009, should host two markets. First, an Organized Market for premier firms meeting international accounting and transparency standards, and an OTC (Over-The-Counter) market for smaller firms, targeted at attracting a large number of companies into the local market. According to The Syria Report, eight to nine firms are expected to start trading in the Organized Market, mainly private banks and insurance players, and an additional 14 companies are foreseen to join within the first year of operations. The DSE's launch is widely anticipated by the market, and is seen as an essential step in affirming Syria's economic and financial modernization, improving the country's visibility on the regional financial services map.

2. CONCLUSION

While official estimates maintain that growth in 2007 was 6.6%, the Economist Intelligence Unit estimates it at 4.3% and the International Monetary Fund puts it at 3.9%. Both the IMF and EIU are expecting the economy to slowdown in 2008, where the EIU expects a 3.9% real growth and the IMF forecasts it at 4.0%. Such a slowdown expectation is actually largely owed to falling oil output. The agriculture sector is also expected to remain depressed this year, after another poor harvest. These negative trends will be partly offset by continued expansion in the services sector, boosted by solid growth in tourism and demand for goods and services, in part from the large Iraqi refugee population.

In the year ahead, Syria could witness a slowdown in private consumption offset by a net growth in the investment aggregate. Growth in private consumption could weaken as a result of lower disposable incomes owing to cuts in fuel subsidies and higher inflation. Also, the impact of the influx of Iraqi refugees on consumption levels would start to wane as many run down their savings, some return and visa restrictions limit the number of new arrivals. In parallel, Syria should continue to attract investment from a number of regional countries, especially Arab Gulf countries, Iran and Russia. Likewise, merchandise exports should continue to rise in 2008, owing to the increase in oil prices, which will temporarily offset the negative impact of falling oil production and reduced wheat exports owing to a poor harvest. Import spending growth should also remain strong, partly because of the ongoing process of tariff liberalization, in addition to a healthy demand for capital goods related to some large infrastructure and construction projects.

Inflation, in parallel, is expected to continue to rise in 2008. The Economist Intelligence Unit expects an inflation rate of around 16.8% in the year ahead, owing to significant reductions in fuel subsidies in March and May and to a 25% increase in government salaries and pensions. Such a price phenomenon has in fact accelerated this year with a number of international factors lifting prices at the same time, of which we mention the following: The unprecedented rise in oil prices lifted the price of one barrel to above US$ 100, an all-time record high. The depreciation of the US Dollar against the Euro in an economy that imports a significant part of its needs from Europe also generated an imported inflation. Such dollar depreciation was triggered by the sub-prime crisis leading to outflows towards stronger currency environments. Last but not least, the climatic factors, of which droughts and floods that hit a large number of fields worldwide lifted the price of wheat along with that of other cereals on international markets.

At the monetary policy level, the Credit and Monetary Council of the Central Bank has modified its rules on deposit rates to provide more flexibility for commercial banks. The new system entitles banks to set their time deposit rates in a specific range, in the aim of promoting medium to long term savings thereby increasing the funds available for medium and long term lending. As to exchange rates, a new exchange rate regime has been in place since October 2007, based on a peg to a basket of currencies based on the SDR. It actually resulted in a relative appreciation of the Pound against the US dollar. The Economist Intelligence Unit forecasts that the Pound will appreciate further against the weak dollar in 2008 to an average of 46.4 Pounds per US Dollar, before it undergoes a relative stability the year after.

Within the same context, the Central Bank has been actively reducing the restrictions on foreign currency transactions. Although designed to facilitate investment, the measures should also support the development and promotion of the banking sector. A decree on the issuance of Treasury bills has also been approved, with the proceeds of the issues likely to finance the budget deficit as well as for strategic projects. There are additional plans to launch a local bond market, increasing the number and sophistication of monetary tools available to the Central Bank and helping to contain the inflationary impact of budget deficits at large.

Finally, with regards to fiscal policy, it is broadly expected that Syria's fiscal deficit in 2008 will remain substantial, though lower than that of 2007. The Economist Intelligence Unit expects a fiscal deficit to GDP ratio of 4.5% in 2008, while the International Monetary Fund forecasts the same ratio at 4.8% (46.9% for the debt to GDP ratio in 2008 from 49.2% in 2007). The ongoing deficit is attributable to increases in public sector salaries and higher government purchase prices for crops, offset by a substantial reduction in fuel subsidies. One factor helping to reduce the deficit in 2008 will be earnings from the telecommunications sector, as the government's share of mobile phone revenue increases from 40% to 50% and as third generation services are introduced.