

Syria Economic Report

LARGELY UNDERUTILIZED DOMESTIC RESOURCES WITH PENT-UP GROWTH POTENTIAL

In the course of the past five years, the Syrian economy was characterized with a moderate growth environment within the context of significant needs for structural reforms. Private demand has suffered from the lack of adequate financing, which restricted its leverage effect on growth. Over the 1999-2003 period, private investment represented on average a mere 6% of Syria's aggregate demand, while aggregate investment was merely 15% of demand. Given the significantly high Incremental Capital to Output Ratios (ICOR levels), the relatively low capital formation was behind the observed growth rate estimated at an average of 2.8% per annum over the period. In parallel, private consumption which rose on average by 1.9% annually, within the context of a modest disposable income, was not able to play the needed regulatory role on aggregate demand.

Bearing in mind the persisting domestic hindrances to economic growth, the Syrian government has been embarking on considerable structural adjustment reforms targeting a sound growth in local economic value added. Syria looks increasingly committed to renovating the legal and fiscal environment, reforming and computerizing the government administration, upgrading the customs regime and opening-up the domestic banking sector. These orientations aim at helping create the needed hundreds of thousands of jobs annually and generating durable and sustainable real growth rates in output and income per capita.

Syria's National Accounts 1999-2003

	Real growth per annum	Average share in aggregate demand/supply	Contribution to aggregate demand/supply growth
Gross domestic product	2.8%	76.7%	2.2%
Imports	2.5%	23.3%	0.6%
Aggregate supply	2.7%	100.0%	2.7%
Total consumption	3.1%	56.8%	1.8%
Private consumption	1.9%	47.5%	0.9%
Public consumption	9.3%	9.3%	0.8%
Total Investment	8.8%	15.1%	1.3%
Private investment	4.3%	5.7%	0.2%
Public investment	11.5%	9.3%	1.0%
Exports	-1.4%	28.1%	-0.4%
Aggregate demand	2.7%	100.0%	2.7%

Sources: Central Bureau of Statistics, Syrian Statistical Abstract, Bank Audi's Research Department

The Syrian economy is evenly distributed over primary and secondary sectors on one hand (accounting for an average of 55.6% of GDP over the 1999-2003 period) and tertiary sectors on the other hand (accounting for the remaining 44.4%). Mining and manufacturing actually account for the lion's share of total output (27.2%), followed by agriculture (25.1%), wholesale and retail trade (16.8%), transport and communication (12.7%), government services (8.8%), finance and insurance (3.6%), building and construction (3.3%) and social and personal services (2.5%). The breakdown of economic growth by sector however shows that economic sectors performed unevenly over the past five years. Agriculture and government services have seen their shares in output increasing (+1% and +2.4% respectively) at the detriment of mining and manufacturing (-1.6%) wholesale and retail trade (-1.7%) and finance and insurance (-0.9%) over the period. Other sectors shares in aggregate output remained relatively steady over the period.

A detailed analysis of the recent developments in the real, monetary, government and foreign sectors of the Syrian economy follows. The concluding part of the report looks at the growth potential of the economy, currently characterized by largely underutilized resources and a wide gap between actual output and potential output.

1. REAL SECTOR

1.1. Agriculture

Agriculture activity plays a significant role in the Syrian economy. The output of the sector was SP 406 Billion in 2003, equivalent to almost a quarter of the Syrian economy's total output for the year. Agricultural output grew at a CAGR of 7.7% (5.7% in real terms) over the 1999-03 period, of which value-added output rose by 7.5% during the five-year period. Growth had averaged a healthy 8.7% from 2000 to 2002 but contracted by 2.7% in 2003.

Vegetable and animal production have been growing annually since 1999, showing a CAGR of 6.6% and 9.4% respectively, over the 1999-2003 period. Vegetable and animal production peaked at SP 261 billion and SP 136 billion in 2003, respectively. Most of agricultural and animal production goes to meet domestic demand, but what has also helped the sector's growth is foreign demand, as agricultural exports grew by 21.9% annually over the 2000-03 period. Agricultural price increases have been negligible both at the wholesale and retail levels, as retail price inflation grew at 0.2% for the 2000-03 years and wholesale price inflation was negative at -0.2% during the same period. The recent price trends yet signal a resumption of inflation at both the retail and wholesale levels.

1.2. Energy and manufacturing

The manufacturing sector has been steadily growing annually since 2000, as it rose at a CAGR of 5% during the 2000-2003 period, with total output reaching SP 379 billion in 2003. The growth rates of key sub-sectors of manufacturing over the covered period reflect the sector's demand. Textile and clothing grew by an average of 12.1% per annum, manufacturing, food and tobacco increased by 8.5%, while chemical industries and petroleum rose by 1.2%. In parallel, the import of industrial machinery has exhibited steady growth over the past four years. Such imports show a 15.5% increase per annum over the 2000-03 period, peaking at SP 66 billion in 2002.

Industrial exports have been modest, growing at a rate of 5.1% over the covered period. Mineral fuels and lubricants account for the vast majority of manufactured exports and grew at a CAGR of 5.1% during the past four years. When excluding mineral fuels and lubricants, industrial exports show a growth of 5.9% over the covered period.

Output of crude petroleum rose by a modest CAGR of 3.3% for the 2000-2003, peaking at 36,222 million cubic meters in 2002, while phosphate grew at a CAGR of 3.5% during the same period, also peaking in 2002 at nearly 2.5 million tons. Fuel oil production rose by a CAGR of 10.2% over the 2000-02 years to nearly 6 million tons in 2002, but gas oil and coke production regressed by 1.6% and 17.3%, respectively, during the covered period. Additionally, water production reached 1.08 billion cubic meters in 2003 with a growth of 3.1% for the 2000-03 period and electricity production showed a CAGR of 5.7% over the same period, gradually increasing year-on-year to reach 28,264 million KWH in 2003.

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Agriculture

SP million	1999	2000	2001	2002	2003	Var 00/99	Var 01/00	Var 02/01	Var 03/02	5-y CAGR
Gross agricultural output	301,031	340,523	379,377	394,847	405,592	13.1%	11.4%	4.1%	2.7%	7.7%
Agricultural imports	-	35,652	34,331	39,646	41,899	-	-3.7%	15.5%	5.7%	5.5%
Agricultural exports	-	20,491	22,208	44,240	37,117	-	8.4%	99.2%	-16.1%	21.9%
Retail price inflation (foodstuff)	-	-5.7%	5.0%	-1.9%	3.9%	-	10.7%	-6.9%	5.8%	0.2%
Wholesale price inflation (foodstuff)	-4.4%	-8.3%	-5.0%	6.3%	4.0%	-3.9%	3.3%	11.3%	-2.4%	-0.2%

Sources: Central Bureau of Statistics, Syrian Statistical Abstract, Bank Audi's Research Department

1.3. Construction

Construction activity plays a significant role in the Syrian economy. The output of the construction and building sector was SP 109 billion in 2003, equivalent to 5.9% of the Syrian economy's total output for the year. Construction output grew at a CAGR of 12.4% over the 2000-03 period, of which value-added was estimated to have risen by 9.8% during the covered period and accounted for 35% of total output in 2003. The overall sector grew by an annual rate of 3.1% during the covered period and peaked at 8% in 2003.

The sector has experienced satisfactory growth since the turn of the decade, driven by a strong continuous demographic growth. As a result of increasing demand, licensed construction areas show a

substantial 22.7% on average over the last five years, while the number of vehicles progressed by 5.5%. The communications sector, while still lagging behind the regional performance, underwent an improvement over the last five years reflecting the country's efforts towards greater global integration and openness.

The tourism sector depicted a dynamic activity over the last five years due to the rising attraction of Syria as a tourism destination, especially Arab tourists, who are increasingly considering the region as an alternative to Europe or the US following the September 11 attacks. The end of the Iraq war has further boosted the tourism sector recently, due to large inflows of visitors from Iraq, mainly driven by business and trade interests. Tourism activity is also gaining ground as the Syrian government, with the help of the

Energy and Manufacturing

SP million	1999	2000	2001	2002	2003	Var 00/99	Var 01/00	Var 02/01	Var 03/02	5-y CAGR
Gross industrial output	561,824	631,701	603,456	634,393	663,679	12.4%	-4.5%	5.1%	4.6%	4.3%
Industrial imports	-	151,883	186,413	196,108	194,870	-	22.7%	5.2%	-0.6%	8.7%
Industrial exports	-	195,699	220,971	257,313	227,922	-	12.9%	16.4%	-11.4%	5.2%
Crude petroleum production (m3 000s)	33,320	31,688	33,568	36,222	34,912	-4.9%	5.9%	7.9%	-3.6%	1.2%
Electricity production (KWH mn)	21,568	23,946	25,544	26,896	28,264	11.0%	6.7%	5.3%	5.1%	7.0%

Sources: Central Bureau of Statistics, Syrian Statistical Abstract, Bank Audi's Research Department

CAGR of 54% over the 2000-03 period, peaking at 6.6 million square meters in 2003. The growth is evident in both residential and non-residential buildings, but residential activity accounts for more than three quarters of total licensed areas. Permits for residential construction rose at a CAGR of 54.1% over the 2000-03 period to nearly 5.13 million square meters in 2003, while those for non-residential buildings exhibited an equally healthy 53.7% growth rate over the covered period and jumped by an annual 106.3% to 1.47 million square meters in 2003.

The average cost of completed buildings grew by 18.1% over the 2000-02 period, reaching SP 5,070 per square meters in 2002. The rise was mostly driven by a 30.4% increase in the cost of residential building activity that reached SP 6,641 per square meter in 2002. This was largely due to shortages in cement, with cement production growing by 8% over the 2000-02 period to 5.4 million tons in 2002 but increasing by a mere 0.4% during the 1999-2003 years and regressing to 5.2 million tons in 2003. Authorities lifted in September the existing ban on cement imports to address shortages and ease rising prices but imports have been allowed up till the first half of 2005.

1.4. Trade and services

The trade and services sector witnessed a relatively healthy performance over the past few years, as the economy was gradually modernizing and enhancing its infrastructure in light of a flourishing tourism activity and a steadily growing domestic and foreign demand.

The transport and telecommunications sector depicted an improved overall performance over the last five years. The sector revealed an average growth rate of 6.7% in nominal terms and of 4.9% in real terms over the period. Maritime activity revealed a dynamic trade activity, as the volume of merchandise at Syrian ports progressed by 12.4% on average over the last five years. The number of ships using Syrian ports increased by a mild 1% over the same period. Air passengers' activity further reflected the improvement in the transport sector as the total number of passengers at Syrian airports showed a progression of 4.1% on average over the same period. In addition, the number of passengers by railways increased by a

European Union, is seeking to promote cultural tourism and preserve the national heritage given the rich tradition of historical and religious sites in the country. The number of arrivals to Syria progressed by around 13% on average over the last five years. Lebanon accounted for 37.7% of arrivals in 2003, followed by Jordan with 17.2%, Turkey with 10.7%, Saudi Arabia with 8.2%, Iraq with 5.8% and Iran with 4.9%. However the major increase in the number of arrivals was that of the Iraqi arrivals which number registered an average growth of 44.5% per annum over the past five years.

2. FOREIGN SECTOR

Foreign trade witnessed a rise in activity over the past four years, as the volume of foreign trade progressed by around 12% on average over the period. The observed improvement occurred as a result of a growth in both imports and exports due to both quantity and price effects, including the rise in oil export volumes and the surge in international oil prices. The average growth in exports stood at around 7.0% per annum over the past four years, while that of imports registered 8.1%.

The geographical distribution of domestic exports showed that Italy received the largest share of Syrian exports at about 33.2% in 2003. France came in second place with 14.4%, followed by Turkey with 7.5%, Saudi Arabia with 5.9%, Lebanon with 4.0%, Spain with 3.9% and the USA with 3.7%. The shares of these countries in total exports sum up to more than 70% of total exports in 2003.

China proved to be the largest supplier to Syria, and accounted for about 5.9% of total Syrian imports in 2003. Ukraine came in second place with a 5.8% share, followed by neighboring Turkey with 5.7%, the USA with 5.0%, Italy with 4.2%, Saudi Arabia with 4.0% and India with 3.9%. The resultant combined imports from these countries accounted for about 35% of total imports to Syria in 2003.

The structure of exports by product showed that petroleum and petroleum products represented by far the largest share of exports, constituting 71.3% of the total. Food and live animals followed with

Trade and Services

SP million	1999	2000	2001	2002	2003	Var 00/99	Var 01/00	Var 02/01	Var 03/02	5-y CAGR
Foreign trade	-	430,489	509,941	736,492	601,324	-	18.5%	44.4%	-18.4%	11.8%
Number of arrivals (000s)	2,682	3,015	3,389	4,273	4,388	12.4%	12.4%	26.1%	2.7%	13.1%
Merchandise at Syrian ports (tons 000s)	8,016	8,473	7,772	12,421	12,803	5.7%	-8.3%	59.8%	3.1%	12.4%
Ships at Syrian ports	5,773	5,494	5,618	5,879	5,940	-4.8%	2.3%	4.6%	1.0%	0.7%
Telephone main lines (000s)	1,600	1,674	1,817	2,099	2,414	4.6%	8.5%	15.5%	15.0%	10.8%
Mobile subscribers (000s)	-	27	192	400	1,150	-	611.1%	108.3%	187.5%	249.2%

Sources: Central Bureau of Statistics, Syrian Statistical Abstract, Bank Audi's Research Department

12.7%, manufactured goods and articles with 9.2% and crude materials (except fuels) with 3.9%. At the level of imports, manufactured goods and articles constituted the bulk of total imports, representing 31.1% of the total. Machinery and transport equipment followed with 26.2%, food and live animals with 15.6% and chemicals and related products with 14.9%. These four categories alone accounted for more than 85% of total imports in 2003.

The government was also keen to promote the foreign trade sector over the last few years and has concluded several bilateral trade agreements with countries in the region including free trade agreements with Jordan, Saudi Arabia and the United Arab Emirates. More recently, the Syrian government initiated the EU Association Accord in Brussels as a preliminary step towards its implementation. The accord stipulates the establishment of a free-trade area in the Euro-Med region by 2010. According to the Syrian government officials, the accord would allow the country to benefit from technical cooperation in its reform efforts and institutions building as well as export promotion.

3. PUBLIC SECTOR

The state of public finances revealed an overall expansionary fiscal trend over the last five years, which falls within the government economic policies of fighting unemployment and creating jobs given the accelerating population growth rates.

The average growth of public expenditures approximated 13.3% per annum over the last five years (1999-2003). Public expenditures were equally distributed between current and capital expenditures. Over the same period, current expenditures increased by 11.9% while capital expenditures progressed by 14.7%. The increase in current spending has largely resulted from important increases in salaries and rises in pensions. Over the past five years, the year 2003 witnessed the largest increase in spending of about 17.8%.

Government revenues were positively affected by the surge in international oil prices over the last few years. The distribution of revenues by sources reveals an average growth of 14.3% in taxes and duties per annum over the last three years. These have accounted for about 37% of total revenues on average over the last three years and have contributed by a similar amount to the average growth in revenues over the period. However, the major source of government revenues remains oil exports revenues, which account for about half of export revenues and about 20% of GDP.

Over the last few years, the government has adopted several structural reform measures at the legislative and regulatory level to improve the stance of its public finances, as part of its comprehensive

economic reform and liberalization plans. The government took an important step towards the modernization of the tax system for the purpose of enhancing collection, raising efficiency and fighting tax evasion. Accordingly, a new "Income Tax Law" was introduced in 2003 aiming at enhancing transparency and simplifying taxation procedures, and another more recent new consumption tax law was enacted in 2004 with the objective of simplifying duties on goods. In parallel, government reduced income taxes in early 2004, imposed high penalties for evasion and adopted stringent collection guidelines. Further important reforms were introduced in the disclosure of statistics, as the budget spending plans were brought closer to international standards, and unveiled greater transparency and accuracy and more solid accounting procedures.

Last but not least, the State Planning Commission (SPC) is in the process of setting up a new five-year economic plan, which should be presented to parliament in March 2005. The plan is expected to bring about economic reform measures aimed at promoting private sector involvement in the economy and enhancing efficiency and productivity in the economy at large.

4. FINANCIAL SECTOR

4.1. Monetary situation

The analysis of Syria's monetary statistics, as published by official sources, reveals a relative liquidity weakness. The ratio of aggregate money supply to GDP stood at 76% on average for the period 1999-2003, one of the mild levels in the Middle East and North Africa region. M1 represents 65% of money supply in the large sense, underlying the significant dimension of the cash economy. The liquidity weakness results essentially from the scarcity of bank loans to the private sector, whose average contribution to money supply growth represented a mere 7.6% over the 1999-2003 period. Despite the weakness in domestic money creation, money supply has been growing by an annual average of 117 billion Syrian pounds over the five-year period, the equivalent of an 18.1% compounded average growth rate.

Within this context, net foreign assets in Syria have been building up at an average rate of 20% per annum over the past five years, mainly as a result of higher oil earnings. With net foreign assets exceeding US\$ 12.5 billion at year-end 2003, the equivalent of 73% of aggregate money supply, the Syrian government introduced measures loosening restrictions on private banks excess foreign currency money, yet still subject to the prior approval of the Central Bank.

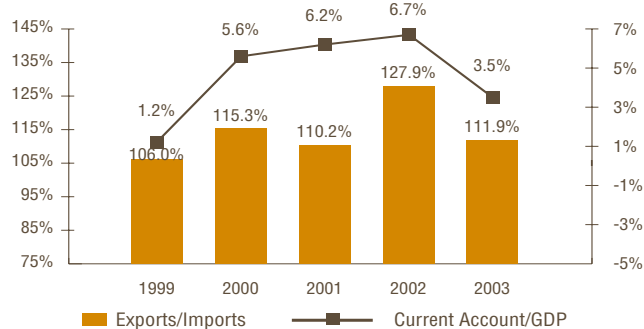
The monetary policy in Syria, that was characterized by a multiple fixed exchange rate system, rigid interest rates, and a direct government control over the banking system, has witnessed lately some changes moving towards more flexibility and responsiveness to market conditions. The difference in the multiple exchange rates was slightly reduced, as the official "neighboring countries" exchange rate was devalued at the beginning of 2004 to get closer to the black market rate, implying possible unification in the future. Despite these developments under a relatively closed economy, inflationary pressures remained contained, in line with the modest growth in domestic demand. The average annual inflation rate has been around 1.2% over the past five years.

A money market for bank liquidity is a prerequisite for the establishment of appropriate monetary conditions in Syria. Most bank liquidity is currently placed as cash in vault at zero percent,

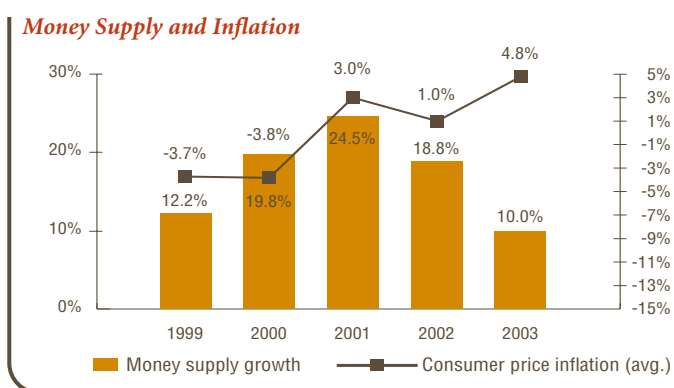
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Foreign Sector Indicators



creating a major burden on monetary development at large. There is no money market infrastructure. There should be a market for government bonds and private securities providing an investment vehicle for the bank liquid placements. The government should allow financial intermediaries to trade different types of equities and bonds and to undertake the operations of an open market and discount window at the Central Bank at different rates. Besides opening up new opportunities for private banks to invest liquidity in interest bearing instruments, the increased market liquidity could enable the Finance Ministry to issue Treasury bills and use their proceeds to finance development projects.



4.2. Banking activity

The weakness of financial services remains one of the critical issues behind the relative sluggishness of economic performances. The Syrian banking sector is currently characterized by a relatively weak mobilization of domestic and offshore savings and a bad channeling of savings towards private productive investment, the main engine for growth and job creation. Syrian banking needs actually extend over different business lines and services within the context of a quasi-absence of adequate banking coverage despite the enactment of important governmental reforms.

The banking industry accounted for US\$ 14.4 billion of total deposits at end-2003, the equivalent of 56% of total bank assets and 63% of Syria's GDP. It is covering a network of 276 branches, equivalent to one branch per 64,000 inhabitants, against a regional average of one branch per 25,000 inhabitants and an emerging countries average of one branch per 15,000 inhabitants. Total bank loans to the private sector accounted for a mere 26.8% of Syria's GDP (13.3% for private sector loans), against a regional average of 37.5% and an emerging countries' average of 69.1% of GDP. Bank lending suffers from the weakness of institutional disclosure and the lack of a track record in the borrowing and settlement experiences of private enterprises and individuals.

The success of the economic and market liberalization efforts largely depends on the adequacy and openness of the regulatory environment, the competitiveness and liberalism in private sector operations, and the independence of financial institutions in financing decisions based on internationally set standards. Within this context, the Syrian government's willingness to upgrade its financial infrastructure constituted an undeniably promising initiative, which has been conceptually welcomed by investors at large. On a practical level, a number of operational hurdles have been arising. There is today an increasing need for speeding the overall financial sector reform process and addressing the strengths and weaknesses of such a process.

Several areas still require urgent banking reform. The liberalization of foreign exchange transfers, for example, is very important for the development and outgrowth of banking activity in Syria. Flexibility in the movement of foreign exchange across the country is likewise much needed. The banking sector operating framework is also characterized with significantly high fees on banking transactions.

For the sector to attract offshore savings and foreign financial activity, the conditions applied by operating banks, in coordination with regulatory authorities, should be competitive by regional standards. With today's perfect capital mobility, financial resources target the financial sectors with optimal transaction costs and remuneration conditions.

The development of retail banking is also key for the success of Syria's banking activity. On top of the direct benefits that retail business brings to the individual and the business community, a social and educational dimension exists. Proximity to clients in order to serve their needs is key to success. Such initiatives cannot but boost the socio-economic development of Syria through a large number of product channels, of which the most important ones are saving and payroll accounts, payment cards, direct debit services, personal loans, bancassurance, in addition to other specialized retail products and services. Such products and services catered to the Syrian clientele constitute an important driver for the improvement in the standard of living and welfare and hence for the stimulation of aggregate demand and output growth.

CONCLUSION: A TWO-FOLD POTENTIAL FOR REAL GDP GROWTH RATES

With an average real output growth below the natural growth of the population over the past five years, the wide gap between actual and potential output is definitely not narrowing. It is estimated that the Syrian economy is currently operating at well below full-employment level. The large cyclical output gap for Syria suggests the economy is operating on the flat Keynesian side of its aggregate supply side curve, and implies a pent-up consumption and investment demand within the context of large growth reserves. In this perspective, there is no doubt that Syria can more than double its current growth rates and for a number of years, whenever the factors weighing on aggregate demand are gradually alleviated.

The low private investment to GDP ratio in Syria, lagging behind world and developing country averages, underlines a weak capital formation ratio. Any growth enhancement assumption for Syria needs to be based on a better channeling of financial resources towards productive investment projects. The issue is to ensure an overall confidence level in the country's structural adjustment prospects that would ensure an appropriate channeling of domestic and off-shore resources to finance the economy's investment needs in the foreseeable horizon.

Driven by a potential private investment-led growth, Syria could be able to undergo a significant economic expansion before reaching a moderate capacity utilization rate. Within the perspective of an acceptable regional settlement scenario, the economic performance of Syria would certainly become much more significant and the opportunities of diversification offered to foreign investors would likewise be much more attractive. Once the favorable conditions are met, we estimate the potential for real economic growth at around 4-6% a year for 5 to 7 years, raising the capacity utilization rate to above the 80% threshold. The GDP growth, within the context of an increase in net current transfers from the Syrian Diaspora, who would be attracted by a genuine opening-up and liberalization of the economy, would lead to a real enhancement in disposable income at large.

In this context, a more dynamic banking sector liberalization policy, in addition to the amendment of certain restrictive laws and regulations, should ensure an important stimulus to economic activity through the channeling of a greater share of savings towards more productive private investment. The gradual potential surpluses in the balance of payments, in addition to the significant financing needs of private and public sectors, could produce, through the effect of the credit multiplier, an important growth in Money Supply, with all positive spillover effects on banking coverage ratios. The resulting increase in the system's aggregate liquidity could ensure self-fulfilling economic growth and financial services development trends, translating into a plausible improvement in the country's overall standard of living and welfare over the years to come.

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