LEBANON ECONOMIC REPORT

THE STOPPAGE OF MONETARY DRIFT HINGING UPON THE CONTAINMENT OF FOREIGN AND FISCAL DEFICITS

TABLE OF CONTENTS

Executive Summary	1
Introduction	2
Economic Conditions	3
Real Sector	3
External Sector	6
Public Sector	7
Financial Sector	8
Concluding Remarks	11

CONTACTS

Research

Marwan S. Barakat
(961-1) 977409
marwan.barakat@bankaudi.com.lb

Jamil H. Naayem
(961-1) 977406
jamil.naayem@bankaudi.com.lb

Salma Saad Baba
(961-1) 977346
salma.baba@bankaudi.com.lb

Fadi A. Kanso
(961-1) 977470
fadi.kanso@bankaudi.com.lb

Gerard H. Arabian
(961-1) 964047
gerard.arabian@bankaudi.com.lb

Farah N. Nahlawi
(961-1) 959747
farah.nahlawi@bankaudi.com.lb

By the time of the finalization of this report, a very large explosion hit the Port of Beirut, with spillovers reaching almost all around the capital. The explosion inflicted large human and material damages unseen in Lebanon since the Lebanese War, with damages exceeding Lebanon's capacity to sustain in the short to medium term. Below is the Lebanon Economic Report for the first half of 2020, i.e prior to the tragic event.

- Economy caught in a depression

The Lebanese economy has fallen in a recessionary trap in the first half of 2020, with the real economy caught in a depression characterized by a significant contraction in real output amid the Corona Pandemic effects and the State's default on its foreign debt. As a matter of fact, real GDP growth is projected at -12% in 2020 as per the IMF Global Economic Outlook released recently. The economic contraction is actually tied to a contraction in private spending in its double components of private investment and consumption, while public spending has reported a standstill.

- A 50% decline in imports leading to a 59% drop in trade deficit in the first five months of 2020

The latest foreign trade statistics released by Lebanon's Customs Authority for the first five months of 2020 suggest a net contraction in imports by a yearly 50.4%, alongside a decline of 7.3% in exports which generated a tangible reduction in the trade deficit by 58.8% over the first five months of 2020 when compared to the first five months of 2019. Within this context, and amid contracting trade deficit, the balance of payments recorded a smaller deficit of US$ 2.5 billion over the first half of 2020, compared to a large deficit of US$ 5.4 billion in the previous year's corresponding period.

- Fiscal deficit contracting by 16% during the first five months of 2020

Lebanon's public finances statistics for the first five months of this year point to a 16.2% contraction in the government's fiscal deficit as a result of a drop in public expenditures by 15.7%, mainly on the back of the tangible decline in debt service (in the aftermath of Lebanon's default on foreign debt payment) and in EDL transfers (following the considerable drop in global oil prices) over the period. In parallel, public revenues went down by 15.4% year-on-year, in light of the economic sluggishness amid weak real sector activity and the state of emergency declaration due to coronavirus over that period.

- Lebanese pound under significant pressures in black FX market

The first half of the year 2020 saw dwindling FX buffers, significant pressures on the Lebanese pound to reach an all-time low against the US dollar on the black FX market, and first interest rate cuts on LP Treasury bills in ten years. The Central Bank of Lebanon's foreign assets contracted by US$ 4.3 billion during the first half of the year 2020 to reach US$ 33.0 billion at end-June, according to official figures released by the Central Bank of Lebanon. Liquid FX reserves are estimated at circa US$ 20.3 billion, excluding Lebanese Eurobond holdings and the FX facilities provided by BDL to commercial banks.

- Deposits still in contraction mode coupled with loan deleveraging

Lebanese banks are continuing to experience quite challenging conditions, within the context of the acute economic and financial crisis hitting the country, depositor concerns and the spillovers of the COVID-19 pandemic disrupting the course of daily business. Banks are continuing to deleverage amid rising credit risks, and many borrowers are settling their dues using creditor accounts, which explains a non-negligible part of deposits' contraction. The aggregated assets of the Lebanese operations of banks operating in the country, reflecting overall sector activity, declined by 7.2% so far this year to reach the equivalent of US$ 201.1 billion at end-June 2020 at the official FX rate.

- Lebanese bond curve converges to teens after default, equities remain on decline

Following Lebanon's first-ever default on its foreign currency debt and the suspension of IMF negotiations after two-month talks, and amid a lack of agreement on financial system's losses, the Lebanese bond curve converged to teens at end-June 2020. Concurrently, Lebanese equities plunged to lows unseen in more than fifteen years amid worsened socio-economic conditions and the lack of implementation of much-needed reforms.

Bank Audi sal - Group Research Department - Bank Audi Plaza - Bab Idriss - PO Box 11-2560 - Lebanon - Tel: 961 1 994 000 - email: research@bankaudi.com.lb

The Lebanese economy has fallen in a recessionary trap in the first half of 2020, with the real economy caught in a depression characterized by a significant contraction in real output. As a matter of fact, real GDP growth is projected at -12% in 2020 as per the IMF Global Economic Outlook released recently.

The economic contraction is actually tied to a contraction in private spending, while public spending has reported a standstill. In fact, private consumption has been adversely impacted by overall economic concerns and increased monetary fears, in addition to the adverse impact of the Coronavirus Pandemic on the consumption behavior at large. In parallel, private investment got a significant hit with most private investors refraining from making any investment decision amid increased economic uncertainties and growing concerns on the politico-economic outlook of the country at large.

The BDL coincident indicator, a weighted average of a number of real sector indicators that coincide with real economic activity, reported an average of 210 over the first five months of 2020, as per the latest BDL statistics, contracting by 30.6% relative to the same period in 2019. Comparatively, the indicator had risen by an average of 1.2% over the past 3 years and by an average of 1.8% over the past 5 years.

Out of 11 real sector indicators, 10 were down and one was up over the first half of 2020. Among indicators with negative growth, we mention new car sales with a decline of 70.0%, the number of passengers at the Airport with a contraction of 69.8%, construction permits with a fall of 59.9%, cement deliveries with a decrease of 56.6%, total imports with a drop of 50.4%, the number of tourists with a fall of 48.3%, merchandise at the Port of Beirut with a contraction of 36.0%, electricity production with a decrease of 12.4%, total exports with a drop of 7.3% and cleared checks with a decline of 3.8% year-on-year. The only indicator with positive growth was the value of property sales with an increase of 97.9% over the first half of 2020 when compared to the previous year's corresponding period.

At the monetary level, the Lebanese pound was subject to significant pressures within the context of a decreasing confidence factor and a contraction in FX reserves of the Central Bank. In fact, BDL foreign assets contracted by US$ 4.3 billion in the first half of 2020 amid FX market intervention and import financing for basic products. When removing sovereign Eurobonds holdings and BDL domestic FX claims on Lebanese banks from the overall BDL foreign asset figure, liquid FX reserves reached today a low of US$ 20 billion, i.e almost half the domestic currency Money Supply.

The first half of 2020 also witnessed increasingly tough operating conditions for Lebanese banks. Customer deposits continued their descent, with the average monthly contraction recording US$ 2.4 billion since the beginning of the year. The contraction was mainly due to a contraction in LP deposits, while FX deposits showed a tiny decline. As a result, deposit dollarization rose to 79.8% in June, its highest level in three decades. Interest rates saw a further significant decline in the first half of 2020. The average LP deposit rate contracted to 4.16% in June, against a high of 9.40% last November. The average US$ deposit rate contracted to 1.64% in June, against a high of 6.61% last October. In parallel, loans to the private sector continued their descent in the first few months of 2020, bringing the year-to-date contraction to US$ 8.4 billion. Since the beginning of 2019, the banking sector loan portfolio contracted by US$ 18.0 billion amid continuous deleveraging on behalf of Lebanese banks.

At the capital markets level, equity and debt markets came under pressure. The BSE price Index reported a contraction of 13.8% in the first half-year despite the improvement in Solidere prices, within the context of a 15.8% annual increase in trading volume year-on-year. In parallel, eurobond yields and CDS spreads skyrocketed over the period amid the default of the State on the totality of its Eurobond portfolio.

The developments in the real sector, external sector, public sector and financial sector for the first half of 2020 will be analyzed thereafter while the concluding remarks are left to an assessment of the Lebanese pound roles amid the drainage of US dollars on the local market.

1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture and Industry

Agricultural and industrial sectors lose steam

Amidst the economic crisis in Lebanon and the adverse effects of COVID-19, the country's primary and secondary sectors came under pressure during the first half of 2020. In fact, agricultural imports notably dropped while exports managed to grow as local goods became more competitive to international buyers. Industrial exports contracted because of difficulties in importing raw materials used in their production, and industrial imports fell amidst a weakening local currency.

On the agricultural front, the sector's exports expanded during the first five months of the year, while imports slightly decreased. Agricultural exports increased by 14.0% during 5M 2020, against a rise of 11.5% in the same period of the previous year. Agricultural imports fell by 25.6% during 5M 2020, compared to a fall of 0.4% in the same period of 2019.

It is worth noting that the development of Lebanon's agricultural sector is crucial to ensure self-sufficiency and reduce the need to import food products, especially for goods that could be locally produced. Consequently, this would limit the export of foreign currencies and ensure a more stable local economy that would reduce its dependence on the external sector.

As for the industrial sector, both imports and exports came under pressure. As a matter of fact, imports of the industrial sector fell by 53.2% annually in the first five months of 2020 after expanding by 11.4% in 5M 2019. Externally, industrial exports decreased by 9.1% from the previous year's level during 5M 2020, against a rise of 8.8% in the same period of 2019.

The Lebanese and Iraqi governments are currently in negotiations to improve trade relations. Iraq agreed to import industrial and agricultural products from Lebanon, while agreeing to export its surplus petroleum products, especially crude oil, to Lebanon.

The Central Bank of Lebanon also announced that it would provide foreign currencies to Lebanese banks to finance the import of basic food items at an exchange rate of LP 3,900 against the US dollar. The requests would be submitted to banks and their value paid in cash in Lebanese pounds to the lenders, which in turn will hand it over to BDL, and the latter will convert them to dollars and transfer them to the correspondent banks accredited to them.

Figures released by the Kafalat Corporation indicate that loans extended to small and medium sized companies under the guarantee of Kafalat totaled US$ 5.7 million in 2019, down by 86.1% year-on-year. Meanwhile, the aggregate number of guarantees amounted to 51 in full-year 2019, decreasing from 313 guarantees given in the previous year.

Looking forward, despite an uncertain outlook for reforms, Lebanon's agricultural and industrial sectors would certainly benefit if the latter happens. Long-awaited reforms would make the Lebanese economy more flexible and less reliant on the external sector. It would also improve foreign investor sentiment, leading to higher foreign investments into the domestic primary and secondary sectors at large.

1.1.2. Construction

Real estate sector perceived as a safe haven amidst economic and financial crisis

The Lebanese real estate market witnessed strong activity in the past few months, with the October 17 revolution and the ensuing exacerbation of the economic and financial crisis spurring significant demand for real estate. Apartments and land are widely perceived as a safe-haven investment, and are sought after by buyers fearing a haircut on their financial investment.

In this context, the statistics published by the General Directorate of Land Registry and Cadastre covering the first six months of 2020 showed that realty markets have undergone a rise in sales activity and an increase in their value. The number of sales operations rose from 21,957 sales operations in the first six months of 2019 to 27,216 operations in the first six months of 2020.

The value of property sales transactions was on an improving path in the first six months of 2020. It posted a rise of 97.9% year-on-year to attain a total of US$ 5,396.3 million during the first six months of 2020. Accordingly, the average sales value increased from US$ 124,163 in the first six months of 2019 to US$ 198,276 in the first six months of 2020. Most regions recorded an increase in the value of sales transactions, with the most significant movements coming as follows: Beirut (+141.6%), Kesrouan (+121.5%) and Baabda (+99.0%).

On the supply side, construction permits, an indicator of forthcoming construction activity, posted a 59.9% year-on-year decrease during the first half of 2020, as most developers slowed down or sometimes halted their construction works. In fact, construction permits covered an area of 1,396,602 square meters in the first half of 2020, against an area of 3,484,825 square meters in the first six months of 2019. This followed a yearly contraction of 30.6% registered in the aforementioned period of 2019. The breakdown by region shows that most of the regions reported contractions in construction permits, with Beirut and Bekaa reporting the highest contractions of 84.2% and 68.8% respectively in construction permits in the first six months of 2020. The country still has a stock of residential properties for sale that accumulated over the past few years. While the current real estate sales upturn is reducing the stock, the latter remains non-negligible and needs to be absorbed before it makes sense for property developers to think in terms of kick-starting new projects.

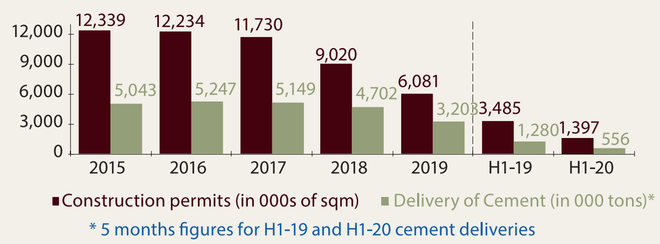
As for the breakdown of construction permits, Mount-Lebanon continued to capture the highest share in newly issued construction permits in the first half of 2020 with a share of 35.2%. It was followed by the North with a share of 23.1%, South-Lebanon with 20.9%, Nabattiyeh with 11.1%, Bekaa with 7.3% and Beirut with 2.5%.

With the economic and financial crisis exacerbating, and a lot of realty being sold relative to previous months, sellers somewhat regained the upper hand in negotiations and some of them even started to increase their asking prices (against bank check payment). What can be ascertained is that the current situation of high demand is likely to prevail at least in the next few months, awaiting drastic measures by Lebanese authorities to deal with the ongoing economic and financial crisis. It might yet be a while before an economic settlement is reached and/or a financial and monetary restructuring is agreed upon.

CONSTRUCTION

	2019			2020			Variation	
	Q1	Q2	H1	Q1	Q2	H1	Q2/Q2	H1/H1
Value of property sales (in millions of US$)	1,625	1,101	2,726	2,335	3,061	5,396	178.0%	97.9%
Number of property sales	12,067	9,890	21,957	14,068	13,148	27,216	32.9%	24.0%
o.w. Sales to foreigners	234	230	464	225	202	427	-12.2%	-8.0%
Average value per property sale (in US$ 000)	135	111	124	166	233	198	109.1%	59.7%
Property taxes (in millions of US$)	82	62	144	99	119	218	92.0%	51.3%

EVOLUTION OF CONSTRUCTION INDICATORS



1.1.3. Trade and Services

Lebanon's tertiary sector comes under pressure in H1 2020

Amidst the adverse impact of the COVID-19 pandemic, Lebanon's tertiary sector witnessed a weak performance during the first six months of 2020, exhibiting negative results at the level of tourist activity, hospitality and airport traffic.

The latest figures released by the Ministry of Tourism showed that the number of tourists posted a 48.3% yearly retreat in the first quarter of 2020 following an increase of 3.7% in the same period of the previous year. In fact, the number of tourists registered 194,395 in the first quarter of 2020, compared to 375,815 tourists posted in the first quarter of 2019.

It is worth noting that the sector posted an overall negative performance all throughout the first three months of the year, with the highest decrease registered in March 2020, as a lockdown was imposed on the country after the spread of the COVID-19 pandemic. In details, Europe and Arab countries got the lion's share in the contribution to the number of tourists with 39.9% (77,620 tourists) and 28.1% (54,695 tourists) respectively. These were followed by tourists from America which took over a share of 16.3% (31,591 tourists). Tourists from Asia came in after with a share of 8.2% (16,011 tourists), while those of Africa followed with a share of 4.4% (8,595 tourists).

Subsequently, and according to Ernst & Young's "Middle East Hotel Benchmark Survey", the performance of Lebanon's hospitality sector witnessed a notable deceleration in occupancy rates, average room rates and room yields during the first five months of 2020. As a matter of fact, the occupancy rate of four and five-star hotels within the capital reached only 14.0% in the first five months of 2020, against 68% in the same period of 2019. The occupancy rate within Beirut was ranked last among 14 cities included in the survey. Beirut's room rate notably moved down from 5M 2019 to attain US$ 129 in 5M 2020 from US$ 192 in the same period of the past year. The rooms' yield contracted by 86.2% annually to reach US$ 18 in 5M 2020 compared to US$ 130 in the same period of the previous year.

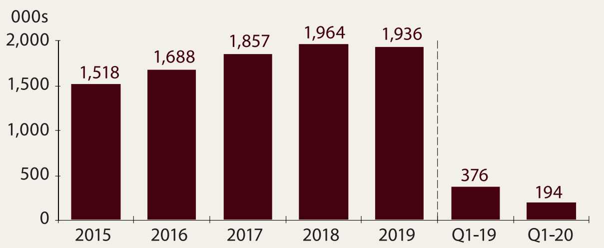
Figures released by the Rafic Hariri International Airport revealed that the total number of passengers recorded a yearly 69.8% decrease in the first half of 2020. The number of aircraft fell by 62.1% year on-year in the aforementioned period. The total freight handled by the airport edged down by 43.5% year-on-year in the aforementioned period. A detailed look at the activity shows that the number of incoming passengers fell by a yearly 72.0% and that of departing passengers by 67.6% to reach 563,930 and 627,697 respectively in the first half of 2020. The number of transiting passengers fell from 25,675 passengers in the first half of 2019 to 15,044 passengers in the corresponding period of this year. When including the latter mentioned category, the total number of passengers using the airport attained 1,191,627, down by a yearly 69.6%.

Moving on to Port activity, there was a yearly 44.3% decline in the Beirut Port's revenues in the first six months of 2020 to reach US$ 56.9 million compared to the same period of the previous year. In parallel, the number of containers recorded an annual decrease of 45.3% to attain a total of 211,535 in the first six months of 2020. The number of ships posted a fall of 14.4% year-on-year to reach a total of 737 vessels in the first six months of 2020. The quantity of goods fell by a yearly 36.0% to 2,245 thousand tons in the first

TRADE AND SERVICES

	2019			2020			Variation	
	Q1	Q2	H1	Q1	Q2	H1	Q2/Q2	H1/H1
Number of ships at the Port	411	450	861	388	349	737	-22.4%	-14.4%
Number of containers at the Port (in 000s)	184	202	386	102	110	212	-45.8%	-45.3%
Merchandise at the Port (in 000 tons)	1,766	1,745	3,511	1,131	1,114	2,245	-36.1%	-36.0%
Planes at the Airport	15,413	18,133	33,546	10,805	1,899	12,704	-89.5%	-62.1%
Number of passengers at the Airport (excluding transit, in 000s)	1,735	2,215	3,950	1,152	40	1,192	-98.2%	-69.8%
Cleared checks (in millions of US$)	14,822	12,669	27,491	16,075	10,381	26,456	-18.1%	-3.8%

EVOLUTION OF THE NUMBER OF TOURISTS



six months of 2020. Transshipments contracted by 12.4% year-on-year to attain 203,419 containers in the first half of 2020, following a rise of 11.9% in the corresponding period of 2019.

Last but not least, the value of cleared checks reached US$ 26,456 million in the first half of 2020, against US$ 27,491 million in the same period of 2019, suggesting a decline in spending in a sluggish economy. A breakdown by currency shows that the banks' clearings in Lebanese pounds amounted to LP 14,342 billion (-7.8%) in the first half of 2020 while those in FC amounted to US$ 16,942 million (-1.4%) over the period.

1.2. EXTERNAL SECTOR

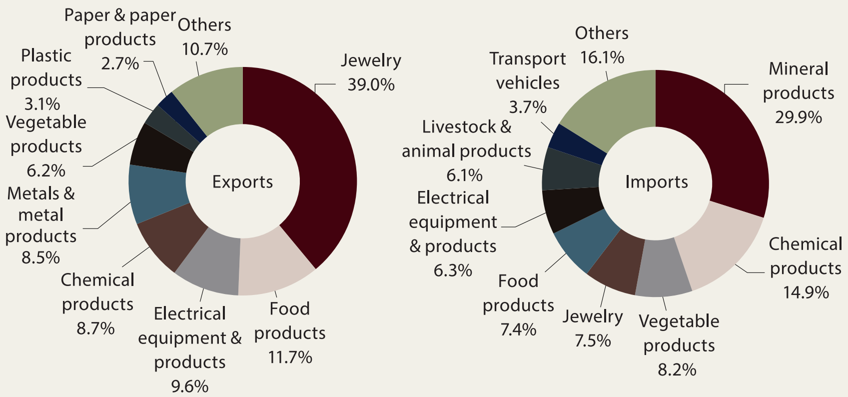
A 50% decline in imports leading to a 59% drop in trade deficit in the first five months of 2020

The latest foreign trade statistics released by Lebanon's Customs Authority for the first five months of 2020 suggest a net contraction in imports by a yearly 50.4%, alongside a decline of 7.3% in exports (mainly in the aftermath of the state of emergency declaration in March), which generated a tangible reduction in the trade deficit by 58.8% over the first five months of 2020 when compared to the first five months of 2019. Accordingly, the sum of exports and imports went down by 44.3% to reach US$ 5.7 billion over the first five months of the year, while the exports to imports ratio reached a high level of 30.7% over the same period, from 16.4% a year ago. Within this context, and amid contracting trade deficit, the balance of payments recorded a smaller deficit of US$ 2.5 billion over the first half of 2020, compared to a large deficit of US$ 5.4 billion in the previous year's corresponding period.

Going further into details, the breakdown of exports by product suggests that the most significant decline among the major categories was reported by plastic products with 43.1%, followed by paper and paper products with 35.7%, chemical products with 26.1%, metals and metal products with 21.5% and electrical equipments and products with 19.0% over the first five months of 2020 when compared to the first five months of 2019. On the other hand, the main items to have displayed an increase were live animals and animal products with 53.8%, vegetable products with 25.8% and jewelry with 20.0% over the same period.

The breakdown of exports by major countries of destination suggests that exports to Syria reported the most significant decline of 50.5% year-on-year, followed by Germany with 27.3%, Greece with 22.0%, UAE with 21.3%, Jordan with 13.2%, Iraq with 12.1%, Kuwait with 11.1% and Saudi Arabia with 10.2% between the two periods, while exports to Switzerland reported a significant increase of 91.5%, followed by Egypt with 16.7% over the same period. It is worth mentioning that land exports through Syria continued its negative trend to decrease by 38.0%, moving from US$ 142 million to US$ 88 million, as all land border crossings into Syria remain closed indefinitely since March 12. In parallel, exports through the Port of Beirut went down by 11.8%, while those through the Hariri international Airport witnessed a relative increase of 9.7% over the same period.

BREAKDOWN OF EXPORTS AND IMPORTS BY COMMODITY*



* 5M-2020

In parallel, the breakdown of imports by product suggests that the most significant decline was reported by transport vehicles with 70.4%, followed by metals and metal products with 69.1%, electrical equipments and products with 63.5%, textiles and textile products with 62.9%, plastic products with 61.2% and mineral products with 57.7% over the first five months of 2020 relative to 2019 same period. The breakdown of imports by country of origin over the same period shows that, among the major partners, imports from China dropped the most by 64.9%, followed by France with 63.9%, USA with 63.8%, Russia with 62.6%, Germany with 48.8%, Italy with 46.1%, Greece with 40.9% and Egypt with 39.6% between the two periods.

1.3. PUBLIC SECTOR

Fiscal deficit contracting by 16% during the first five months of 2020

Lebanon's public finances statistics for the first five months of this year point to a 16.2% contraction in the government's fiscal deficit as a result of a drop in public expenditures by 15.7%, mainly on the back of the tangible decline in debt service (in the aftermath of Lebanon's default on foreign debt payment) and in EDL transfers (following the considerable drop in global oil prices) over the period. In parallel, public revenues went down by 15.4% year-on-year, in light of the economic sluggishness amid weak real sector activity and the state of emergency declaration due to coronavirus over that period. As such, and despite the tangible drop in debt service, the primary balance went up from a tiny primary deficit of US$ 38 million to a large primary deficit of US$ 716 million between the two periods.

A detailed look at public finance statistics over the same period shows that public revenues went down from US$ 4.5 billion during the first five months of 2019 to US$ 3.8 billion during the first five months of 2020, while public expenditures reported a net decline from US$ 6.9 billion to US$ 5.8 billion between the two periods. Accordingly, the public finance deficit went down from US$ 2.4 billion during the first five months of 2019 to US$ 2.0 billion during the corresponding period of 2020.

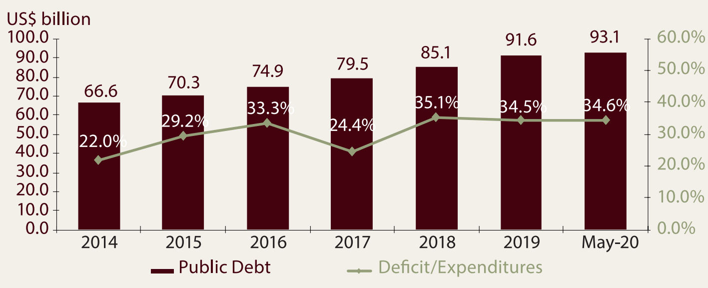
Going further into details, the decline in public revenues between the two periods came within the context of a drop in budget revenues by 25.5% coupled with a considerable increase in Treasury revenues. The decline in budget revenues was due to a 40.0% contraction in non-tax revenues (mainly as a result of a drop in Telecom revenues by 54.5%), while tax revenues reported a tangible decline by 22.6% on the back of a drop in VAT revenues by 51.1% and a decline in custom duties by 37.8%. In parallel, the significant hike in Treasury revenues was triggered by a LP 644 billion refund in April 2020, representing BDL coupons for the months of January, February and March 2020.

In parallel, the net decline in public expenditures over the same period came within the context of a drop in budget expenditures by 17.2% coupled with a 4.0% increase in Treasury expenditures. This drop in budget expenditures was tied to a 45.4% drop in debt service and in EDL transfers by 33.5%, and amid a slight decrease in general expenditures by 0.7% over the first five months of 2020, when compared to the previous year's corresponding period. In parallel, debt servicing totaled US$ 1.3 billion in the first five months of 2020, down from US$ 2.3 billion during the first five months of 2019. In fact, interest payments on LP denominated debt went down by 10.6% to reach US$ 1.1 billion, while debt servicing on FC debt declined by 83.7% to reach US$ 182 million over the same period.

PUBLIC SECTOR DEFICIT FINANCING

in millions of US$	5M-19	5M-20	Progression
Deficit financing	Vol	Vol	Vol
Deficit	2,386	1,998	-388
State creditor accounts	-712	-1,227	-515
Other items	-1,428	727	2,155
Uses=sources	**245**	**1,498**	**1,252**
LP	**1,581**	**641**	**-940**
Treasury bills (banking system)	1,556	392	-1,164
Others	25	249	224
FX	**-1,335**	**857**	**2,192**
Sovereign eurobonds (including Paris II bonds)	-1,150	0	1,150
Others	-185	857	1,042

PUBLIC INDEBTEDNESS



Subsequently, the country's gross debt reached US$ 93.1 billion at end-May 2020, up by 9.1% from the level seen at end-May 2019 and up by 1.6% from end-2019. Domestic debt was higher by 10.0% from end-May 2019 to reach a total of US$ 58.5 billion at end-May 2020. Lebanon's foreign debt went up by 7.6% from end-May 2019 and up by 2.5% from end-2019 to stand at around US$ 34.6 billion at end-May 2020. In this context, net public debt, which excludes the public sector deposits at the Central Bank and commercial banks from overall debt figures, increased by 9.5% from end-May 2019 and up by 3.4% from end-2019 to reach a total of US$ 84.0 billion at end-May 2020.

1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Lebanese pound under significant pressures in black FX market

The first half of the year 2020 saw dwindling FX buffers, significant pressures on the Lebanese pound to reach an all-time low against the US dollar on the black FX market, and first interest rate cuts on LP Treasury bills in ten years.

The Central Bank of Lebanon's foreign assets contracted by US$ 4.3 billion during the first half of the year 2020 to reach US$ 33.0 billion at end-June, according to official figures released by the Central Bank of Lebanon. Yet, it is worth mentioning that the Central Bank Governor said early-July that liquid FX reserves are estimated at circa US$ 20.3 billion. This excludes the Central Bank of Lebanon's Lebanese Eurobond holdings (estimated at US$ 5.03 billion at end-June) and the FX facilities provided by BDL to commercial banks (estimated at circa US$ 8 billion by the end of the first half of 2020).

The Lebanese pound was subject to significant pressures in the black FX market during the first half of the year 2020. The local currency depreciated sharply against the US dollar to reach an all-time low of LP/US$ 10,000 at end-June, before relatively recovering to LP/US$ 7,000-LP/US$ 8,000 levels over the month of July, mainly due to the inflow of cash US dollars from expatriates during the summer season after the reopening of the airport and given BDL's food import subsidy.

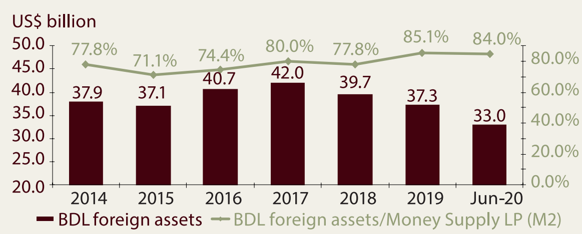
The downward spiral of the Lebanese pound over the first half of 2020 took place despite all successive measures taken by the Central Bank of Lebanon and the money changers syndicate to meet demand for cash US dollars and curb the free fall of the local currency. Given the collapse of the Lebanese pound on the black FX market, Lebanese banks raised at end-June 2020 the exchange rate for withdrawals from US dollar and foreign currency accounts from LP/US$ 3,000 to LP/US$ 3,900. This eventually complies with the exchange rate set by the money changers syndicate at a minimum buying price of LP/US$ 3,850 and a maximum selling price of LP/US$ 3,900.

The significant LP money creation allowed the local currency liquidity to remain quite abundant on the money market, especially during the second quarter of the year 2020. This brought the overnight rate down to 3%, after hitting double-digit levels earlier this year.

MONETARY SITUATION

Flows in US$ million	H1-19 Vol	H1-20 Vol	Progression Vol
Net foreign assets (excluding gold)	-5,364	-3,970	1,393
Net claims on the public sector (excluding valuation adjustments)	-1,314	-7,044	-5,730
Claims on the private sector	-2,919	-7,390	-4,471
Uses=Sources	**-9,597**	**-18,405**	**-8,807**
Money (M3)	-1,363	-5,038	-3,675
Valuation adjustment and other items	-8,234	-13,367	-5,133

EXCHANGE MARKET INDICATORS



The financial system's total subscriptions in LP Treasury bills amounted to LP 6,115 billion during the first half of 2020 against LP 8,334 billion during the same period of 2019, down by circa 27% year-on-year. In parallel, the Central Bank of Lebanon continued to play the role of an intermediary between banks and the sovereign, as reflected by a LP 1,074 billion growth in its LP securities portfolio over the covered period. As to interest rates, LP Treasury bills saw in March and April 2020 their first rate cuts in ten years at a range hovering between 1.80% and 3.00%.

Concurrently, the total LP Certificates of Deposits' portfolio contracted from LP 48,043 billion at end-December 2019 to LP 45,251 billion at end-June 2020, down by LP 2,792 billion, which marks its first contraction since 2016.

1.4.2. Banking Activity

Deposits still in contraction mode coupled with loan deleveraging

Lebanese banks are continuing to experience quite challenging conditions, within the context of the acute economic and financial crisis hitting the country, depositor concerns and the spillovers of the COVID-19 pandemic disrupting the course of daily business. Banks are continuing to deleverage amid rising credit risks, and many borrowers are settling their dues using creditor accounts, which explains a non-negligible part of deposits' contraction. The aggregated assets of the Lebanese operations of banks operating in the country, reflecting sector activity, declined by 7.2% so far this year to reach the equivalent of US$ 201.1 billion at end-June 2020 at the official FX rate.

The major drivers behind such a decline were once again deposits and loans, two major engines of banks' activity in the country. On the one hand, deposits at banks operating in Lebanon contracted by the equivalent of US$ 14.4 billion so far this year, or by 9.0%, to total US$ 144.5 billion. It is yet worth noting that the contraction in June reached US$ 1.8 billion, below the monthly average contraction of US$ 2.9 billion since October 2019.

Around 62% of the total deposit contraction so far this year is attributed to LP deposits, as depositors are either withdrawing their liras or converting them to foreign currencies and blocking the converted amount for a specific period of time. FX deposits account for the remaining 38% of deposit contraction, noting that depositors are either asking for bank checks for transaction purposes or withdrawing their US dollar deposits in liras (mostly at the currently LP 3,900 per US$ exchange rate). Within this context, the deposit dollarization ratio reached a near three-decade high of 79.8% at end-June 2020. Residents accounted for close to 71% of deposit contraction this year.

On the other hand, banks continued their deleveraging practices. Their private sector loan portfolio shrank by an additional US$ 8.4 billion, or 16.8%, so far in 2020, to reach a recent low of US$ 41.4 billion at end-June 2020. Practically all the loan contraction was due to the foreign currency side and to the resident sector. Banks' sovereign Eurobond portfolio also continued to contract this year, with banks

BANKING ACTIVITY

	2019			2020		
in US$ million	Q1	Q2	H1	Q1	Q2	H1
Var: Total assets	**3,268**	**3,229**	**6,497**	**-8,231**	**-7,455**	**-15,686**
% change in assets	1.3%	1.3%	2.6%	-3.8%	-3.6%	-7.2%
Var: Total deposits	**-1,758**	**-394**	**-2,152**	**-9,273**	**-5,088**	**-14,361**
o.w. LP deposits	-493	-1,645	-2,138	-5,093	-3,854	-8,947
o.w. FC deposits	-1,265	1,251	-14	-4,180	-1,234	-5,414
% change in total deposits	-1.0%	-0.2%	-1.2%	-5.8%	-3.4%	-9.0%
Var: Total credits	**-2,057**	**-1,326**	**-3,383**	**-4,754**	**-3,597**	**-8,351**
o.w. LP credits	-890	-584	-1,474	-404	-101	-505
o.w. FC credits	-1,167	-742	-1,909	-4,350	-3,496	-7,846
% change in total credits	-3.5%	-2.3%	-5.7%	-9.6%	-8.0%	-16.8%

reducing their exposure to the Lebanese State as well, leading to a 25% contraction this year in the banks' Eurobond portfolio to reach US$ 10.4 billion at end-June 2020.

In parallel, interest rates continued their descent. Interest rates on LP deposits contracted by 320 basis points this year to reach a new low of 4.16%. Similarly, interest rates on US$ deposits contracted by 298 bps to a record low of 1.64%. Interest rates on LP and US$ loans went down by 225 bps and 335 bps respectively to reach 6.84% and 7.49% at end-June 2020.

Last but not least, banks' equity amounted to US$ 19.6 billion at end-June 2020, down by 5.6% so far in 2020. The sector-wide capital adequacy ratio stood at 10.55% at end-December 2019 as per the latest BDL data (Basle III computation, sovereign risk weighted at 100%).

All in all, Lebanese banks continue to face pressures, but are reducing their private sector exposure (as well as their public sector lending portfolio) at a time when credit risks are mounting. What is henceforth needed is a clear and credible government plan including bold structural reform measures for the domestic economy and a sound financial sector restructuring plan that is fair to all stakeholders. This could serve as a basis for IMF negotiations and ensuing potential international support that would be a prerequisite for a much needed return of confidence.

1.4.3. Equity and Bond Markets

Lebanese bond curve converges to teens after default, equities remain on decline

Following Lebanon's first-ever default on its foreign currency debt and the suspension of IMF negotiations after two-month talks, and amid a lack of agreement on financial system's losses, the Lebanese bond curve converged to teens at end-June 2020. Concurrently, Lebanese equities plunged to lows unseen in more than fifteen years amid worsened socio-economic conditions and the lack of implementation of much-needed reforms.

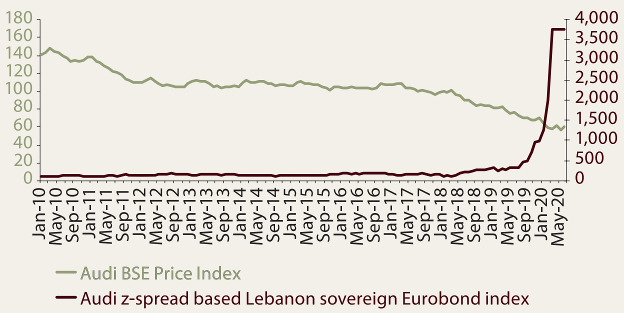
In fact, the Lebanese government's decision to suspend principal and interest payments on Lebanese Eurobonds in March 2020 to prevent further depletion of official FX reserves and the lack of agreement on a rescue plan that would give credibility to government reforms sent Lebanese debt prices into a free fall during the first half of the year 2020.

The Lebanese bond curve converged to teens after default. Prices of sovereigns maturing between 2020 and 2037 ranged between 15.38 cents per US dollar and 18.13 cents per US dollar at end-June versus 44.75 cents per US dollar-87.13 cents per US dollar at end-2019. This followed a CDS auction held on April 23, 2020, which gave Lebanese Eurobonds a final value of 14.125%, thus allowing investors holding

FINANCIAL SECTOR (NON-BANKS)

	2015	2016	2017	2018	2019	Jun-20
Beirut Stock Exchange						
Market capitalization (in millions of US$)	10,496	10,951	10,578	9,117	7,540	6,697
Total trading volume (in millions of US$)	498	885	608	376	197	119
Annualized trading volume/Market cap.	4.7%	8.1%	5.8%	4.1%	2.6%	3.6%
Price index	104.6	106.9	98.2	83.9	69.7	60.0
% change in index	-1.2%	2.1%	-8.1%	-14.6%	-16.9%	-13.8%
P/E ratio*	6.72	6.44	6.38	5.18	5.90	5.88
P/NAV ratio*	0.93	0.91	0.86	0.69	0.57	0.51
Lebanese Eurobonds						
Total volume (in millions of US$)	25,535	26,123	26,123	30,964	28,314	31,314
Average yield	6.1%	6.5%	6.5%	10.0%	30.0%	69.0%
Average life (in number of years)	6.1	6.2	6.7	7.8	7.5	7.5
5-year CDS spreads variation (bps)	26	57	42	229	1,649	-
* For large listed banks						

CAPITAL MARKETS PERFORMANCE



debt protection on Lebanon to receive 86% of the amount covered by the instruments. Under these conditions, the weighted average bond yield reached 69% at end-June 2020 after excluding yields on papers maturing in 2020. This compared to a weighted average yield of 30% at end-December 2019.

In parallel, the Beirut Stock Exchange followed a downward trajectory during the first half of the year 2020, as reflected by a double-digit fall in the BSE price index of 13.8%, amid crippling economic and financial crisis, growing concerns over the fate of IMF talks after Lebanon failed to agree on unified financial system's loss figures, and the lack of implementation of long-overdue reforms which are deemed necessary to unlock promised international support. Under these circumstances, banking stocks plunged in the red over the first half of the year, posting significant price contractions ranging between 16% and 75%. In contrast, Solidere "A" and "B" shares registered a strong price rally of 67%-68% over the first half of 2020, crossing the US$ 12 threshold for the first time since October 2016. This is mainly explained by a shift from bank placements to realty stocks, and on improved sentiment after Solidere announced in June 2020 strong unaudited sales that would be realized over the year 2020.

Double-digit price contractions on the BSE price index were accompanied by relatively increased price volatility on the BSE, as the latter, measured by the ratio of the standard deviation of prices to the mean of prices reached 5.3% during the first half of 2020 as compared to 4.2% during the corresponding period of 2019.

On the backdrop of price falls, the BSE market capitalization contracted by 11.2% during the first half of 2020, moving from US$ 7,540 million at end-December 2019 to US$ 6,697 million at end-June 2020. The BSE total trading value amounted to US$ 119.4 million during the first half of 2020 as compared to US$ 103.1 million during the corresponding period of 2019, up by 15.8%, noting that Solidere shares captured 66% of activity. Accordingly, the BSE total turnover ratio, measured by the annualized trading value to market capitalization, reached 3.6% during the first half of 2020 as compared to 2.5% during the same period of 2019.

Looking forward, amid a continuing domestic financial meltdown and economic collapse, Lebanon's capital markets eagerly await an agreement on a rescue plan that could facilitate negotiations with the IMF, help unlock donor funds, and establish for discussions with bondholders at large.

2. CONCLUSION: THE LEBANESE POUND ROLES AMID THE DRAINAGE OF US DOLLARS ON THE LOCAL MARKET

The Lebanese Pound came under significant pressure on the parallel market in recent times. The reasons of the depreciation of the local currency relative to the US dollar are multiple. First, they revolve around the increased political uncertainties leading to a gradual loss of confidence. Then rises the significant money creation in Lebanese Pound with currency in circulation almost doubling since the beginning of the year amid large fiscal deficits with direct monetization on behalf of the Central Bank. Another reason is the local shortage of US$ amid declining inflows and consecutive balance of payments deficits. It is worth finally mentioning the noticeable smuggling through illegal border routes which also weighs on the currency's market. While the effects of any immediate measure to curtail currency depreciation would remain of temporary nature, a containment of the monetary drift looking forward is conditional upon a positive confidence shock related to political and economic management which in turn hinges upon the launching of signs of a parallel containment of Lebanon's twin deficits, namely its foreign and fiscal deficits and corollarily the State's borrowing requirements.

As the Lebanese banks offshore balances have reached almost nil, it was necessary to fully reestablish all the functions of the Lebanese pound within the Lebanese economic cycle. Lebanese banks placements in foreign banks, which represent the main source of US$ banknotes for their liquidity needs, have reached a record low of US$ 4.5 billion at end-June, while liabilities towards the non-resident financial sector stands at US$ 7.7 billion, suggesting the net FX foreign liquidity position is negative at US$ 3.2 billion. In parallel, liquid reserves at the Central Bank have reached a low of below US$ 20 billion, bearing in mind that they finance the imports of basic consumption products, fuel oil, along with the intervention needs on the parallel FX market.

There are four traditional roles that the local currency of any country should fulfill: (1) a medium of transaction for commercial purposes and shopping in the national currency; (2) a unit of account, i.e. using the national currency for accounting purposes; (3) a store of value with depositors and investors placing their funds in domestic currency term accounts; and (4) a standard of deferred payment with lenders extending credit in the local currency.

The recent developments in Lebanon, notably the lack of US dollars in the market, call for the Lebanese pound to recapture its four traditional roles.

First, the role of the Lebanese pound as a medium of transaction is reinforced, with commercial transactions increasingly effectuated in the local currency. Yet, the latter has not fully regained such a role as significant transactions, especially large ones, are being denominated in US dollars. For instance, we mention the value of cleared checks in Lebanese pounds, which account for less than 38% of total cleared checks, leaving 62% to foreign currencies. Hence the importance of pricing in the local currency by wholesalers and retailers alike, and exclusively using debit and credit cards and checks in Lebanese pounds to increase the use of the Lebanese pound as a medium of transaction for various commercial purposes.

Second, the local currency must regain its role as a unit of account and increasingly serve for accounting purposes. Financial institutions, large corporates and SMEs should utilize the national currency in their accounting exercises. While it is true that some companies need to issue financials in US dollars or euros, such disclosures must complement those in the local currency and not replace them.

Third, the Lebanese pound should regain its role as a store of value especially as the deposit dollarization ratio almost crossed the 80% mark. Efforts have been geared towards reducing interest rates, particularly on foreign currency deposits, for them to be in line with international reference rates which are near zero nowadays. Such an interest rate cut had to be done today especially amid tight restrictions on external transfers in Lebanon. Interest rate cuts widen the gap with interest rates on local currency deposits, and support the lira's role as a store of value.

It is also important for the local currency to partly regain its fourth role that is of no lesser importance than the former three, and that is to serve as a standard of deferred payment, i.e. become the most resorted to currency in lending activities. As a matter of fact, and until end-June 2020, the share of foreign currencies in total credit extended by banks still stands at 64%. The lira regaining its role as a standard of deferred payment with time would without a doubt be a major contributor to supporting financial intermediation and the quality of assets of Lebanese banks in general.

Finally, what is required in this sensitive period of Lebanon's recent history is a collective sense of responsibility and patriotism, along with refraining from propagating rumors that undoubtedly contribute to shaking financial stability and confidence. It is worth recalling in conclusion that the national currency is one of the facets of sovereignty in any country, just as the army and land are, hence the importance of safeguarding it and fully consider it as a pillar of the national economy at large.

Bank Audi sal - Group Research Department - Bank Audi Plaza - Bab Idriss - PO Box 11-2560 - Lebanon - Tel: 961 1 994 000 - email: research@bankaudi.com.lb