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NEW REALITIES IN THE MIDDLE EAST

Middle East and North African (MENA) economies have been buffeted by double blows over the last six years: turmoil after popular revolts in 2011, and the collapse of world oil prices in 2014. There are signs, however, that governments are coming to terms with the new realities.

With conflict continuing in Syria, Iraq, Libya, and Yemen, investors have been skittish, and tourism, once among the region's bigger employers, has been devastated. Governments, faced with lower oil revenues, weakened tax bases, and the cost of housing numerous refugees, have run up huge deficits.


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A BANK TO TRUST

One bright spot has been Egypt, MENA's biggest non-oil-exporting economy, which has only recently begun emerging from the turmoil of the 2011 uprising. Successive governments for years had shied away from tackling the country's runaway budget deficit, lest they further anger a highly charged public.

Late last year the government finally bit the austerity bullet as part of an agreement with the IMF. It devalued its currency by more than half against the dollar, raised fuel prices, and increased its VAT tax by three percentage points to 13 percent. In mid-2017, it increased fuel and electricity prices further, and raised the VAT by another 1 percent.

The long overdue measures have helped reduce Egypt's gaping deficit and have led to a spurt in exports. But they have also caused a one-time leap in consumer prices of over 15 percent in an economy already suffering from high inflation.

The banking sector, largely immune to the political turmoil, appears set to benefit from an acceleration in growth once the economy has absorbed the new reforms.

"I continue to be optimistic about the banking environment," says Hisham Ezz al-Arab, Chairman and Managing Director of the Commercial International Bank (CIB) "It is full of opportunities grounded by the solid fundamentals of the banking system — excess reserves, liquidity, and a strong deposit base. Banks have remained largely unaffected by the economic turmoil of the past six years and kept the country afloat."

QATAR IS WELL POSITIONED TO SIT OUT THE DISPUTE — THE COUNTRY SITS ON TOP OF 13 PERCENT OF THE WORLD'S NATURAL GAS RESERVES.

Other non-oil-exporting countries are likewise anticipating a steady increase in growth.

The GDPs of Lebanon and Jordan, both bordering Syria and playing host to hundreds of thousands of war refugees, each grew by about 2 percent in 2016, a small fraction of the growth seen before 2011. As in Egypt, tourism has slowly been recovering in the two countries.

The Tunisian and Moroccan economies were helped by a rebound in agricultural production after a drought in 2016. Tunisia's GDP grew by 2.1 percent in the first quarter of 2017, up from 1.0 percent in 2016, while Morocco's rose 3.8 percent, up from 1.5 percent.

MENA's energy-exporting countries face a wholly different sort of problem with the collapse in the price of oil. In mid-2014, Brent crude plummeted to around $55 per barrel following a flood of production from North America's fracking industry. It has remained there since, and it looks unlikely that prices will ever return to their former high levels.

For the first time since the global financial crisis, Saudi Arabia's economy suffered a quarterly contraction, falling by an annual 0.5 percent in the first quarter of 2017, mainly due to production cuts agreed at a November 2016 OPEC meeting. The kingdom's non-oil GDP expanded in the same quarter by 0.6 percent, although economists say it, too, seems to have recently been weakening.

Saudi Arabia, the Arab world's biggest economy, has placed its hopes for weaning itself off oil in a plan called Saudi Vision 2030, announced in April 2016 by Muhammad bin Salman, who has since been appointed crown prince and heir to the throne. The plan includes selling up to 5 percent of the shares in Aramco, the state oil company, in an initial public offering, probably sometime in 2018. The Saudi government has put the value of the company at $2 trillion.

The sale of Aramco shares, along with austerity measures, should help reduce a budget deficit that soared to $75 billion in 2016, or more than 10 percent of GDP, as the result of the sharp fall in oil revenue. In September 2016, the Saudi government cut subsidies on gas, electricity, and other goods and services and reduced the salaries of its civil servants.

The UAE's economy, second only to Saudi Arabia's among Arab countries, has been slowing, as well. Among the most diversified of the energy exporters, the IMF expects its economy to grow by 1.3 percent in 2017, with a 3.3 percent increase in non-oil activity more than compensating for a 2.9 percent contraction in oil revenue. Its economy should get a major stimulus from Expo 2020, scheduled to be held in Dubai. The construction sector is already gearing up, with contracts worth $1.5 billion awarded and another $3 billion on the way over the next 12 months. The country is counting on 25 million visitors to the exhibition, which will be built on 438 hectares. The Dubai government plans to finance the project with a combination of equity and debt.

Qatar's economy, based mainly on natural gas, suffered a damaging blow on June 5 when Saudi Arabia, the UAE, Bahrain, and Egypt, angry at its support of the Muslim Brotherhood, broke off diplomatic relations with the country and blocked their air, sea, and land passages.

The dispute has created uncertainty and short-term supply disruptions, but the long-term effects will be minimal, it seems. Qatar continues to export gas to its neighbors, and it quickly began importing goods via Oman instead of Dubai. Turkey, Iran, and Morocco, among other countries, have promised to increase food and other exports to Qatar.

The situation caused imports into Qatar to fall 36 percent in June compared to a year earlier, disrupting the economy, and the central bank had to sell $10.4 billion in foreign reserves, partly to keep its currency steady against the dollar after the sanctions prompted some banks and portfolio managers to pull funds out of the country.

The ratings agency Fitch in late August downgraded the country's sovereign debt to AA- from AA, still considered high investment grade; It said the government had prepared scenarios for scaling back its capital spending plans.

Yet Qatar is well positioned to sit out the dispute, in which there are still no signs of resolution: its sovereign wealth fund, estimated at $180 billion, is one of the world's biggest, while the country sits on top of 13 percent of the world's natural gas reserves. — *Patrick Werr*

LEBANON:
RESILIENT TO ITS CORE

Long weighed down by political instability, Lebanon's economy is seeing hopes of relief after movement on long-delayed and crucial political reforms, a pickup in tourism, and the passage of energy legislation that is allowing the government to offer offshore exploration licenses in one of the Mediterranean's most promising regions for natural gas.

The economy has been buffeted by a range of troubles, both external and domestic. Chief among these is the Syrian civil war, which has scared away tourists and foreign investors, and sent more than 1.5 million refugees flooding into Lebanon. Coping with the refugees, who comprise a quarter of Lebanon's population, has put immense strain on the government's finances.

Lebanon's oil exports were reduced by the collapse in international oil prices in mid-2014, which had, among its knock-on effects, slowed remittances from Lebanese working abroad — traditionally an important support to Lebanon's banking system and to its government's ability to finance its budget deficit.

Lebanese politics had been in disarray for years. The country had not had a president since May 2014, and had not elected a new parliament since 2009. With Lebanon's various sectarian factions unable to agree on a new election law, the sitting parliament instead unilaterally renewed its four-year term in 2013. The regional instability and domestic political paralysis reduced investment, exports, and capital flows, and put huge pressure on public finances.

External forces beyond refugees

To top it off, an agreement to allow the militant group and political party Hezbollah to join the government raised Saudi ire, prompting the Gulf kingdom in early 2016 to withdraw an annual $4 billion in promised security aid and to ban its tourists from Lebanon. The UAE banned its tourists, as well.

The U.S., none too happy with Hezbollah either, enacted legislation in December 2015 to force Lebanese banks to close the accounts of members and affiliates of the group, which has strong support among the country's Shi'ites — more than a quarter of the population. This

Q&A

RIAD T. SALAMÉ

GOVERNOR, BANQUE DU LIBAN

What can the new government do to improve Lebanon's economic performance? What structural reforms are needed?
To ensure sustainable development and to pave the way for real inclusive growth, the government needs to undertake a number of structural reforms: revamping infrastructure, enhancing the quality and quantity of public services, simplifying administrative procedures, enforcing fiscal discipline, reforming the energy sector, and passing the budget law, among others. The BDL has strived to create an adequate environment to promote the banking and financial sectors on one hand, and the knowledge economy system on the other. We hope the government will, in turn, seek to create the necessary environment for cross-sector economic growth.

> **"THE BANKING SECTOR IS HIGHLY LIQUID, WHICH WILL STRENGTHEN CONFIDENCE IN THE SYSTEM AND IN THE LEBANESE POUND."**

Has there been progress in finding new areas of growth, such as gas and oil, and the technology economy?
There are three promising sectors that can give some leverage to the traditional economy: the financial sector, the oil and gas sector, and the digital knowledge economy sector. Lebanon can create a competitive edge and stimulate inclusive growth by focusing on these. The BDL has launched various schemes to guarantee the necessary funds for at least two of those—the financial and the knowledge economy sectors.

To date, and after only three years of implementation and more than $600 million in dedicated funding, the Lebanese knowledge economy has attracted 800 startups, created 6,000 jobs, and increased the national wealth by around $1 billion. This promising sector will soon account for more than 2 percent of GDP and is expected to grow by around 7–9 percent per year in the coming three years.

Remittances from Lebanese working abroad declined yet again in 2016, according to the World Bank.
Remittances are still affected by low oil prices and by the economic challenges that the Gulf countries are facing. Total remittances were estimated at around $7.3 billion in 2016, which is lower than the previous year. Yet they still account for around 15 percent of GDP, on average.

Furthermore, private-sector deposits increased by 8 percent in 2016, [much of which is made up of] remittances from various countries.

We expect remittance flows to remain the same in 2017, if not increase. In any case, the banking sector is highly liquid, which will strengthen confidence in the system and in the Lebanese pound.

Can we expect a new wave of bank consolidation in coming years?
Our objective has always been to develop and maintain a healthy and competitive banking system. And our policy vis-à-vis consolidation has remained consistent: Take preemptive measures by favoring and supporting mergers rather than bank exits or failures. As long as banks are fully implementing our circulars, which are in line with international standards and best practices, the sector will remain stable, sound, and resilient.

In the past year we have seen one merger, but we do not foresee a major wave of consolidation in the near future, as our banking sector is highly liquid, profitable and growing year on year.

Has Lebanon mitigated the effects of the huge influx of Syrian refugees since 2011?
The spillover effects of the Syrian crisis are still hindering the growth of the Lebanese economy. The challenges have affected health, education, and infrastructure, in addition to key economic indicators, namely balance of payments, consumption, and investment, with total economic losses of around $13 billion, according to the U.N.

We remain hopeful that the government will be able to secure the necessary funds to compensate for these losses and to help mitigate the refugee crisis's economic effects. ●

did nothing to help the country's precarious political balance.

The ratings agencies had downgraded Lebanese sovereign debt to "highly speculative."

"The global and local contexts over the past few years have not been favorable for the Lebanese economy," says Riad T. Salamé, Governor, Banque du Liban, the Lebanese central bank.

"Political paralysis, security challenges, regional unrest, the Syrian crisis, and the persisting global economic stagnation have hampered economic growth. Yet the Lebanese economy remained resilient, predominantly because of the efforts deployed by the central bank to safeguard monetary and economic stability," he adds.

Demonstrating remarkable resilience despite the turmoil, Lebanon's economy has continued to grow, edging up by 1.8 percent in 2016, according to the World Bank, an improvement on the 1.5 percent recorded in 2015. Although a far cry from the heady days before the civil war broke out next door, when growth averaged 8.5 percent from 2007 to 2010, it is still a respectable pace.

Economists expect growth to speed up in the next few years as the country comes out of the worst of its travails. Moody's is predicting GDP growth to hit around 3 percent this year, and again in 2018.

Getting its house in order

Much of the optimism springs from the country finally beginning to put its long-dysfunctional political house in order. After having gone without a president for 29 months, the Lebanese in October 2016 finally elected veteran politician Michel Aoun as president.

A new cabinet was quickly assembled, and in June it joined with parliament to approve a new election law for the legislative body. The law yet again extended the current parliament's term, until May 2018, when new elections are set to take place, giving the country time to prepare for the vote.

INCREASED POLITICAL STABILITY ALSO PROMISES TO HELP REINVIGORATE LEBANESE TOURISM, ONCE A MAINSTAY OF THE ECONOMY BUT SEVERELY DIMINISHED BY THE SYRIAN WAR.

The political reforms have already started making a difference.

Some of the Mediterranean's most promising natural gas exploration territory lies offshore from Lebanon, but for years the government had been unable to put a licensing process together that would enable exploration.

Nearby, other countries over the last decade had uncovered a rapid succession of huge gas fields similar in total geological acreage to those off Lebanon's shores: Israel, in 2011, uncovered the 22 trillion cubic feet (tcf) Leviathan field and the 10 tcf Tamara gas field; Cyprus, that same year, found the 4.5 tcf Aphrodite field; and Egypt, in 2015, announced its 32 tcf Zohr field, the biggest ever uncovered in the Mediterranean.

In January of this year, the new cabinet issued decrees setting out the terms and conditions for exploration and production agreements. The government then announced a bid round for licenses for five offshore blocks, three of them in the prime region along Lebanon's maritime border with Israel. Lebanon's energy minister, Cesar Abi Khalil, went on the road in July to market them, with a bid deadline of Sept. 15, and the announcement of winners is scheduled for Nov. 15. Lebanon is hoping for a commercial discovery by 2019.

Hope for tourism bounce

The increased political stability also promises to help reinvigorate Lebanese tourism, once a mainstay of the economy but severely diminished by the Syrian war. The industry has been gradually recovering over the last few years, and in 2016 the number of tourists arriving rose to 1.69 million from 1.52 million the year before. This was the highest since war broke out in Syria in 2011.

The increase occurred despite the Saudi and UAE travel ban. The number of Saudi, Emirati, and Kuwaiti tourists, with their relatively high purchasing power, slid by two-thirds from 2011 to

Q&A
SAAD AZHARI
CHAIRMAN AND GENERAL MANAGER, BLOM BANK

In the past year, Lebanon elected a president, appointed a new cabinet, and approved a new election law. How important will this be for the economy? And what are the priorities for the economy?
All of these factors have surely been beneficial to growth. That is why we are looking this year to growth rates of at least 2 percent, driven by higher tourism, exports, and investments. Among the short-term priorities are the ability to control deficits, maintain the exchange rate peg, and keep trade and export routes open and viable. Long-term priorities include improving the investment and governance climate, developing our infrastructure and oil and gas resources, and strengthening our tradable and IT sectors.

"BY ALL OBJECTIVE MEASURES THE BANKING SECTOR IS OVERCROWDED AND CAN AFFORD MORE MERGERS AND ACQUISITIONS."

BLOM Bank completed the takeover of HSBC's Lebanese assets in June. How has the absorption process been going?
The three HSBC Lebanon branches were very successfully merged with BLOM Bank on June 17. HSBC Lebanon brought with it $473 million in loans, $599 million in deposits, and $841 million in assets. More importantly, it also brought to us a wealth of experience in corporate loans and trade finance that will enrich our operations in these areas, besides introducing new ways to improve business and customer relations in an increasingly digital age. In addition, the merger will increase our balance sheet, but its effect will be mostly felt qualitatively, not quantitatively. We expect the merger to start yielding good profits next year, after all the acquisition costs have been absorbed this year.

How are your operations outside of Lebanon? How have the reforms in Egypt over the last year affected your bank?
Our foreign operations are doing very well, contributing close to 30 percent of our overall activities. In Egypt and Jordan, we are among the leading banks in retail activity. In Saudi Arabia, we are also leading in terms of asset management funds, especially in real estate, and we have just launched the first smart beta fund in the Middle East in cooperation with MSCI Emerging Markets. In the UAE, we remain very active in corporate banking and trade finance. As to Egypt, although BLOM Bank Egypt has been negatively affected by the Egyptian pound devaluation, our overall activity and profitability in U.S. dollar terms is still growing.

Do you expect the Lebanese banking sector to consolidate over the next few years?
By all objective measures the banking sector is overcrowded and can afford more mergers and acquisitions. In fact, we have seen a few consolidations in the past couple of years that have reduced the number of commercial banks to below 50. One of those was, of course, the merger of the three HSBC Lebanon branches with our bank. We remain open to suitable acquisitions if they can provide us with the same fit, but I can't see this happening at the moment.

How has your investment banking been performing?
Investment banking suffered globally after the financial crisis of 2008, and Lebanon was no exception. It has gotten better lately, including at BLOMINVEST Bank, our investment banking arm. We have recently re-expanded our investment banking entity, and we are working on several transactions in Lebanon and abroad. I also see more investment banking taking place in the near future as more capital market activities get underway with favorable developments in the oil and gas and IT sectors, and with more economic growth in general. ●

just over 68,000 in 2016. Still, since 2011 an increase in tourists from Europe, up 16 percent to 564,000, and the U.S., up 33 percent to 297,000, has taken up much of the slack. Early this year, Saudi Arabia removed its ban, a signal that 2017 is likely to be even better.

The revenue from natural gas and tourism should eventually be a welcome boost that will help plug the huge gap in government finances, but in the meantime the government has a serious problem on its hands. The budget deficit is expected to reach $5.2 billion this year, and the World Bank estimates that as of the end of 2016, the debt-to-GDP ratio had soared to 157 percent. This was the third-highest among all medium to large countries in the world, behind only Japan and Greece.

The deficit has traditionally been financed with the help of remittances from Lebanese working abroad. The remittances are deposited in Lebanese banks, which in turn use them to buy government debt. As of June 2016, 28 percent of bank assets were in government securities and 40 percent in deposits at the central bank or in excess reserves. But remittances have been falling in recent years, and in 2016 slipped 2.3 percent to $7.3 billion. This represents about 15 percent of GDP, which despite the decline is still among the highest in the world.

The fall in remittances led to a 10 percent decrease in Lebanon's international reserves in the year to May 2016, a development that prompted the central bank to begin an operation to increase its reserves that started in June 2016.

Under the operation, dubbed "financial engineering," the central bank acquired reserves from the commercial banks in exchange for purchasing their Lebanese pound debt at a handsome profit for the banks. In return, the banks were expected to retain this profit to increase their capital to meet the requirements of the International Financial Reporting Standards scheduled to be implemented in 2018.

The operation boosted Lebanon's international reserves to $41 billion, only slightly under the IMF's metric for adequacy.

"The BDL's latest financial engineering scheme successfully reversed the balance of payment deterioration," says Salamé. "This unconventional initiative had a positive impact on the Lebanese economy overall and surely helped lessen the impact of the Syrian crisis indirectly."

Proof of resilience

The weakening remittances and reserves also prompted the central bank to call in the IMF and World Bank in 2016 to do a stress test of the Lebanese financial system. The Financial Sector Assessment Program (FSAP) tested to make sure the country's banks could withstand various possible shocks, including a worsening of the Syrian civil war, a deterioration in the domestic political situation, a collapse in local real estate prices, a faster-than-expected rise in U.S. interest rates, and sentiment among emerging-market investors turning negative.

> "THE ENDEAVORS WE ARE UNDERTAKING TO BUILD THE KNOWLEDGE ECONOMY AND ITS ENTIRE ECOSYSTEM HAVE THE POTENTIAL TO ATTRACT INVESTMENTS TO LEBANON."

The team completed its report in November. "The FSAP findings confirmed the resilience of the financial system and its effective supervision, notwithstanding the staff recommendations to further strengthen and develop the system," says Freddie Baz, Chief Strategist, Bank Audi.

The Lebanese banking system, Baz adds, "remains an atypical case of financial stability despite a series of extreme events: the civil war [1975-1990], foreign occupation [1980-1992], political assassinations [including Prime Minister Rafic Hariri in 2005], a very destructive war with Israel in the summer of 2006, two recent political vacuums resulting from failures to elect a president [2010 and 2014], and protracted political disagreements."

The banking system seems even to be weathering the anti-Hezbollah controls that the U.S. government is working to strengthen. The Lebanese are concerned that new legislation the U.S. has been preparing would tighten the controls to the extent that correspondent banks, fearing possible fines, would be afraid to do business with Lebanese banks. They have argued to U.S. authorities that any fight to block funding to Hezbollah needs to be balanced with the need to keep Lebanon stable. The U.S. seems to be listening.

At this point, the action that the financial system seems to need the most is for the government to get its massive budget deficit under control. The government has not had a proper budget since 2005. This is likely to change soon; in March, the new cabinet approved a budget and sent it to parliament for approval.

The government says the budget should reduce the deficit to 8.7 percent of GDP, from 9.5 percent in 2016, partly by raising $1.2 billion in new taxes, including a 1 percent increase in Lebanon's value-added tax. The budget, however, includes a $800 million increase in the salaries of government employees, a cost that limits any potential deficit reduction.

In the meantime, the government has resorted to tapping financial markets to plug the difference. In March, it sold $3 billion in Eurobonds.

Banks expand

Lebanon's banks so far appear to be largely immune from the government's financial difficulties. Flush with funds from remittances, banks have been investing abroad. Two of the biggest, BLOM Bank and Bank Audi, have both moved to expand regionally.

"In our case, regional expansion was a must more than a choice," says Audi's Baz. "When your domestic assets reach about half the size of your country's GDP, I wonder how you can still generate efficiency gains and benefit through economies of scale. This is what pushed us to expand in 2005 and build visible franchises in countries such as Egypt, Jordan, and Turkey, among others."

Audi's foreign assets now represent 41 percent of its total assets and 49 percent of its earnings, while BLOM says its foreign operations contribute close to 30 percent of its overall activities.

"In Egypt and Jordan, we are among the leading banks in retail activity. In Saudi Arabia, we are also leading in terms of asset management funds, especially in real estate," says BLOM's Azhari. "In the UAE, we remain very active in corporation banking."

Within Lebanon, banks are focusing their attention on developing financing for small- and medium-size enterprises (SMEs), part of a central bank initiative to divert funds to a sector that comprises 90 percent of the country's enterprises and employs 82 percent of the private labor force.

BLOM has been building its SME loans program to the point where SMEs now make up 21 percent of its $7.1 billion total loan portfolio. Audi moved strongly into SME lending in August 2016, allocating $663 million to the task, of which $160 million was approved over the following nine months. Audi says it is charging the SMEs only 7 percent interest, compared to an average 11 percent marketwide.

The move to lend to SMEs is partly the result of central bank pressure and incentives — plus an infusion of funds from international lending agencies. In July, the European Investment Bank lent 265 million euros to several Lebanese banks to support SMEs as well as mid-cap companies. This goes hand-in-hand with a plan by the central bank to develop what it calls the "knowledge economy."

"We are designing an electronic trading platform that will provide the necessary equity and liquidity for SMEs and boost investment in the Lebanese knowledge economy, since it will facilitate the access of people around the world to the Lebanese markets," says Salamé of the central bank.

"All the endeavors that we are undertaking in building the knowledge economy, and its entire ecosystem, have the potential to attract investments to Lebanon, mainly from Lebanese expatriates." — *Patrick Werr*