



**Page 3**  
 Consumer spending trailing behind confidence

**Page 4**  
 Inflation softened by May on lower oil prices

**Page 5**  
 Tourism recovery goes into full swing

**Page 6**  
 Profit growth at Alpha Group banks slowed in Q1 2017

**Page 7**  
 Latest data for Lebanon's key economic sectors

**Page 8**  
 Key trends in the Lebanese economy

## FISCAL POLICY TO GUIDE GROWTH AS POLITICAL RISK ABATES

- International aid helps fuel public works projects
- Growth in insurance premiums accelerated in Q1 2017
- Bank lending activity lagged behind through April

The Lebanese Parliament approved in June a long-awaited parliamentary elections law and scheduled the next polls for May 2018, ending more than four years of political uncertainty and opening the door for rival parties to address key pending economic legislation.

The passage of a new elections law averted a political crisis, and demonstrated the ability of rival parties in Lebanon to achieve compromises, stated Fitch, a credit ratings agency. According to Fitch, the elections law is unlikely to significantly change the country's sectarian political system, but its passage could improve the prospects for policymaking, especially in relation to the reinvigorated oil and gas licensing process and the budget for 2017.

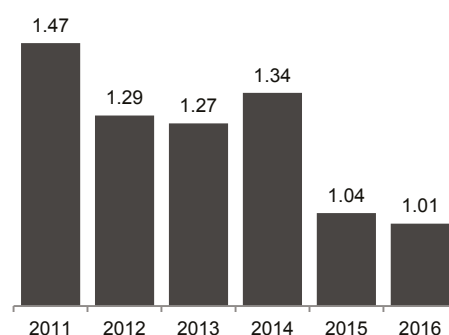
Political consensus is also likely to reflect positively on support from the international donor community as the government returns as an active force behind the Lebanese economy. In June, the World Bank and the Islamic Development Bank announced a \$150m support package aimed at boosting the country's healthcare services and offsetting part of the fallout of the Syrian refugee crisis on Lebanon.

An additional \$404m are estimated to have been allocated by the World Bank for road rehabilitation and education projects targeting locals and Syrian refugees, helping further fuel public works projects and likely providing some relief to contractors.

Consumer confidence is also expected to reap the benefits of the political agreement over an electoral law. Higher confidence levels, however, have so far failed to translate into meaningful gains in private consumption, especially of durable goods, amid persistent constraints to household income and leverage.

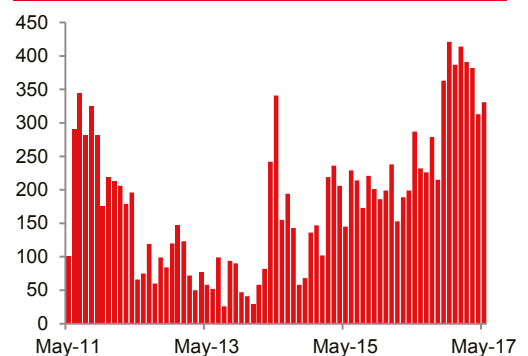
Consumer confidence improved by an average of 23.5% yoy in the first five months of the year, driven largely by positive perceptions of the security situation in the country. However, new passenger car registrations, a proxy for spending on durable goods, fell by 3% yoy to 13,836 vehicles through May, their lowest level in five years, data by the Association of Car

Net production of housing loans (\$bn)



Source: Bdl, ABL, Economena, SGBL Research

Consumer confidence index: security



Source: ARA, Economena, SGBL Research

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Importers showed. Nevertheless, private consumption is still projected to rise by 3.8% in 2017, according to Business Monitor International, riding partly on general retail activity in the capital and resilient demand from high-income earners.

**INFLATIONARY PRESSURES MAY BE BUILDING UP**

At the same time, clearing the electoral law milestone opened the door to renewed deliberations over equally contentious subjects, particularly the public sector salary scale and the means to finance the ensuing additional spending. The new salary scale entails an estimated \$800m in additional spending by the government, and the Cabinet had proposed in early 2017 a series of tax measures targeting businesses and consumers to raise the necessary funds.

Uncertainty over the fate of the salary scale law and its related taxes could weigh on confidence levels and may even provide some tailwind to inflation in coming months. Lebanon’s consumer prices were unchanged in May for the second month in a row mirroring a similar trend in domestic fuel prices. Risks of imported inflation have already increased in recent weeks as a stronger Euro is likely to start seeping into domestic prices. The Euro appreciated by 8.2% in the first six months of the year against the US Dollar, to which the Lebanese Pound is pegged.

**TOURISM AND INSURANCE MAKING HEADWAY**

Meanwhile, the tourism sector is riding a wave of improved security and political stability to recover some of the vibrancy it lost over the past five years, with arrivals increasing by 17.5% yoy to a seven-year high of 503,805 tourists in the first four months of the year. And after several years of near-complete absence, tourists from GCC states began to trickle back into the country following lukewarm improvement in political ties with Lebanon. Arrivals from Saudi Arabia doubled to 19,630 visitors through April, but remain at just 41% of their peak for the period in 2010.

As a result, occupancy rates at Beirut’s 4- and 5-star hotels touched a five-year high of 70% in May 2017, and the revenue per available room (RevPAR) increased by 6.3% yoy to \$101, survey data by Ernst & Young showed.

The tides may also be starting to turn for Lebanese insurance companies. Written premiums increased by 4.5% yoy to \$287.5m in the first quarter of 2017, compared to growth of just 0.3% yoy in the final quarter of 2016, preliminary data compiled by the Association of Insurance Companies of Lebanon (ACAL) showed. Life insurance premiums, which contributed to 24.3% of the total, grew by 11.7% yoy to \$69.7m by March, while non-life segments posted a more humble growth rate of 2.4% over the same period.

**BANKING ACTIVITY LAGGED BEHIND THROUGH APRIL**

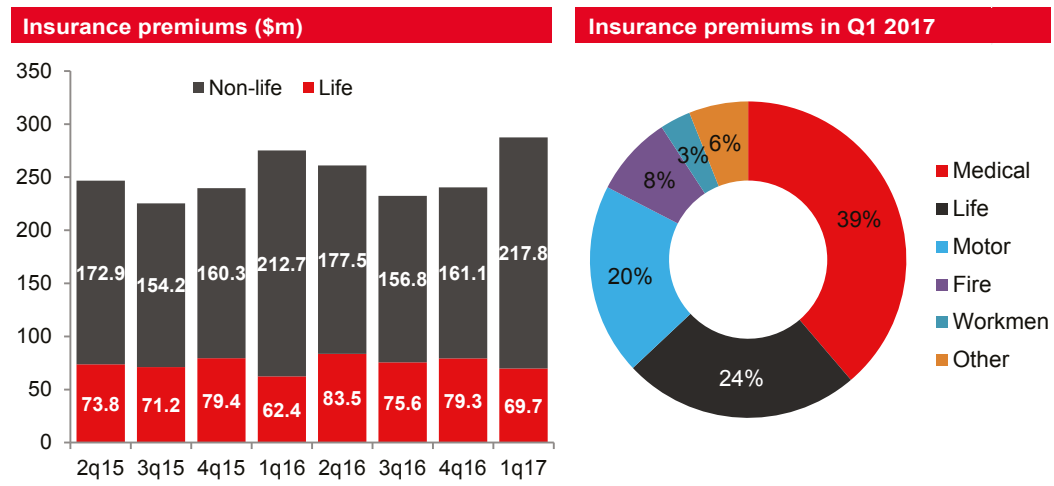
Tepid growth in bank credit poses a risk to the fragile economic improvement. Lending activity slowed considerably in the first four months of the year as banks effectively hoarded cash to take advantage of any possible future rounds of financial engineering by the Central Bank. Credit to the private sector grew by just 4.3% yoy to \$57.6bn through April 2017, with net loan production down by 58.4% yoy to \$405.6m over the period.

Waning demand for real estate and construction projects is in part behind to the slowdown in loan growth. Net production of housing loans stagnated at \$1bn in 2016, a slump of 31.3% from its level in 2010, and has likely softened even more in early 2017.

On the other hand, banks appear intent on further expanding their war chest of foreign currencies. Customers’ deposits surged by 8.2% yoy to \$165.5bn through April, including a jump in foreign currency deposits of 11% yoy to \$109.8bn over the same period.

The Euro appreciated by 8.2% in the first six months of the year against the US Dollar.

Net production of housing loans stagnated at \$1bn in 2016, a slump of 31.3% from its level in 2010.



Source: ACAL, Economena, SGBL Research

Source: ACAL, Economena, SGBL Research

## CONSUMER SPENDING TRAILING BEHIND CONFIDENCE

- Consumer confidence improved by 23.5% through May 2017
- Sluggish economy holding back new passenger car sales
- Private consumption to increase by 3.8% in 2017 - BMI

Higher levels of consumer confidence failed to stoke to a meaningful recovery in private consumption in the first few months of 2017 amid persistent constraints to household income and leverage. Consumer confidence improved by an average of 23.5% yoy in the first five months of the year, driven largely by positive perceptions of the security situation.

However, new passenger car registrations, a proxy for spending on durable goods, fell by 3% yoy to 13,836 vehicles through May, their lowest level in five years, data by the Association of Car Importers showed. Sales at Hyundai were hit the hardest, plunging by 631 vehicles to 1,615 vehicles in the first five months, and other popular brands including Toyota, Nissan, and BMW reported similar, albeit less pronounced, drops in their passenger car sales.

Fewer car sales reflect more cautious lending practices at Lebanese banks as well as lower employment levels in the private sector. Credit to the resident private sector grew by \$493.8m through April 2017, a contraction of 27.2% in loan production from the same period in 2016. Non-housing credit to individuals, including personal and car loans, had surged by 84.4% yoy to a six-year high of \$715.4m in 2016, but appears to have slowed or leveled off so far in 2017.

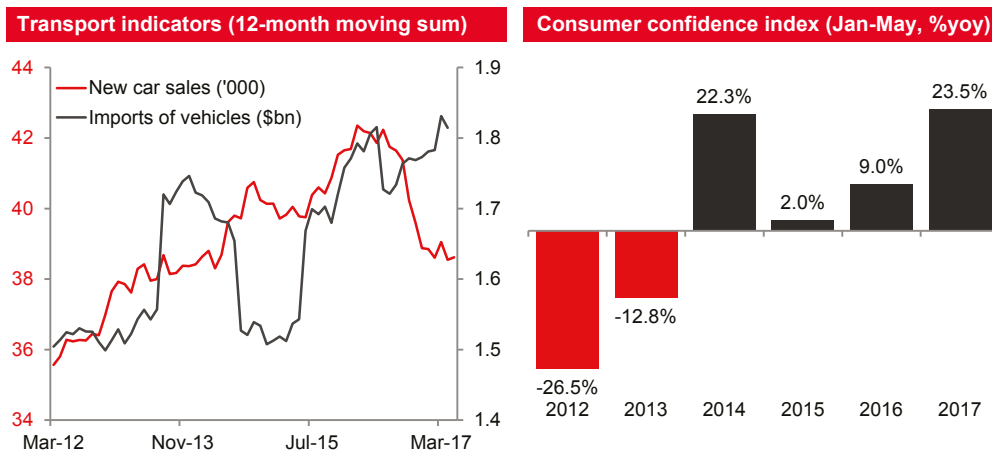
*Non-housing credit to individuals, including personal and car loans, had surged by 84.4% yoy to a six-year high of \$715.4m in 2016, but appears to have slowed so far in 2017.*

The labor market also appears to be going through a rough patch, with the number of firms reporting a decline in employment levels in the fourth quarter of 2016 exceeding those reporting an increase in headcount, according to BdL's business survey.

Despite pressures from a sluggish economy, private consumption is projected to rise by 3.8% in 2017, according to Business Monitor International, riding partly on general retail activity in the capital and resilient demand from high-income earners. The Retail Trade Index published by the Beirut Traders Association increased by 2.7% yoy in the first quarter of 2017, its fastest pace in over four years.

Imports of vehicles inched up by 0.5% yoy to \$1.8bn in the 12 months through April, suggesting a stable outlook for demand in the transportation sector as a whole, even as new passenger car sales lag behind. Similarly, imports of pharmaceutical products rose by 2.4% yoy to a seven-year high of \$414.1m in the first four months of the year, pointing to greater resilience among defensive sectors, particularly healthcare.

Confidence levels among high-income earners more than doubled following the political breakthrough at the end of 2016, providing a consumption force to be reckoned with. Sales of Porsche, Maserati, and Land Rover units all posted double-digit growth in the first five months of the year, a combined increase of 29.8% yoy to 344 vehicles during the period.



Source: Customs, AIA, Economena, SGBL Research

Source: ARA, Economena, SGBL Research

# INFLATION SOFTENED BY MAY ON LOWER OIL PRICES

- Consumer prices unchanged in May 2017 as fuel prices falter
- Salary scale and related tax measures could provide tailwind to inflation
- Inflation tame in Beirut and Mount Lebanon, accelerating elsewhere

Lebanon’s consumer prices were unchanged in May for the second month in a row, mirroring a similar trend in domestic fuel prices. The Consumer Price Index, however, showed price levels were still 4.3% higher in May 2017 than a year earlier, according to data by the Central Administration of Statistics.

Lebanon’s consumer prices typically move in sync with global crude oil prices, and the latter have plunged in recent weeks amid a persistent glut in global oil supply. Brent crude prices fell to \$47.9 bbl by June 30, down from \$56.8 bbl at the end of 2016, which may help soften domestic consumer prices in the second half of the year.

On the other hand, risks of imported inflation increased in recent weeks as a stronger Euro is likely to start seeping into domestic prices. The Euro appreciated by 8.2% in the first six months of the year against the US Dollar, to which the Lebanese Pound is pegged. An estimated 33.2% of Lebanon’s imports, equivalent to \$2.1bn, originated from the Euro area in the first four months of 2017, the latest period for which data are available.

Prices may also get some tailwind from renewed debate over a new public sector salary scale. The approval of an elections law by Parliament in June has cleared the way for deliberations over a salary scale that sees public sector salaries rising by an estimated \$800m a year.

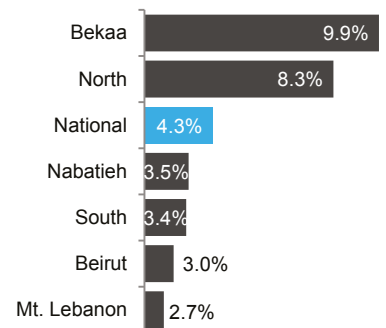
The Cabinet proposed in early 2017 to finance the new salary scale through a series of tax measures on businesses and consumers, which would likely contribute to higher consumer prices and upward pressures on wages in the private sector.

Despite the macroeconomic nature of price drivers, inflation levels have diverged widely across Lebanese districts. Beirut and Mount Lebanon saw the slowest increase in prices in the country, up by 3% yoy and 2.7% yoy respectively by May 2017.

By contrast, consumer prices surged by 9.9% yoy in the Bekaa and by 8.3% yoy in North Lebanon partly driven by demographic pressure from the large Syrian refugee populations in the two districts.

Prices of clothing and footwear, however, accelerated significantly across all districts through May 2017, reflecting a surge in global cotton and synthetic materials prices over the past 12 months. Food prices also increased at a faster pace in the 12 months through May 2017, buoyed by rising prices of milk, cheese, and vegetables in the early months of 2017.

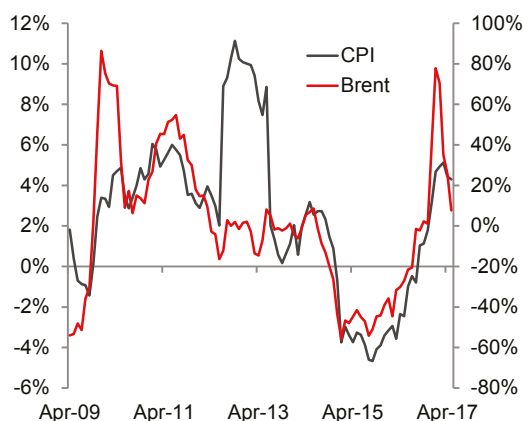
## CPI by region (May 2016, % yoy)



Source: CAS, Economena, SGBL Research

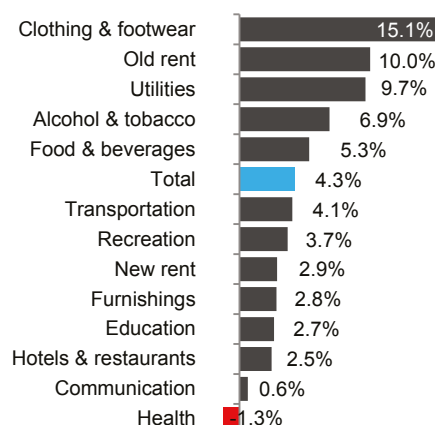
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## CPI and Brent crude (% yoy)



Source: CAS, FRED, Economena, SGBL Research

## CPI by commodity (May 2016, %yoy)



Source: CAS, Economena, SGBL Research

# TOURISM RECOVERY GOES INTO FULL SWING

- Tourist spending rebounded in the first quarter of 2017
- Visitors from Saudi Arabia reached a five-year high by April
- Tourism sector may grow by 2.9% in 2017 - WTTC

Recovery in Lebanon’s tourism sector went into full swing in the first four months of 2017 as arrivals touch a seven-year high and visitors from the Gulf Cooperation Council begin to trickle back into the country. The total number of visitors increased by 17.5% yoy to 503,805 tourists through April, the second highest on record for the period.

As a result, occupancy rates at Beirut’s 4- and 5-star hotels hit a five-year high of 70% in May 2017, and revenue per available room (RevPAR) increased by 6.3% yoy to \$101, survey data by Ernst & Young showed.

Lebanon’s security situation made a turnaround following the implementation of a national security plan in 2014, ending two years of sporadic sectarian clashes and suicide bombings. Consumer confidence in the country’s security improved by 71.8% yoy in the first five months of 2017 to its highest level in at least seven years, aided by a rare political breakthrough among rival parties in late 2016.

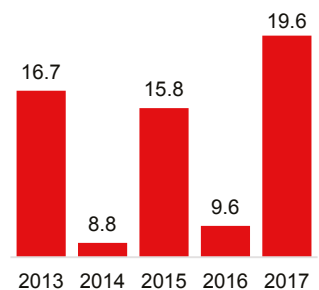
At the same time, a recent uptick in security incidents across major regional and global cities is helping moderate the perception of safety in Lebanon among expatriates and foreigners. Arrivals from European countries and the United States rose by 13.8% yoy to 163,002 visitors and by 10.9% yoy to 35,419 visitors respectively, both record highs for the period.

However, Iraqi visitors continued to dominate the tourism sector in Lebanon. Arrivals from Iraq surged by 31.8% yoy to a record 80,020 visitors in the first four months of the year, representing 15.9% of all arrivals during the period. And after several years of near-complete absence, Gulf tourists started to trickle back into the country following lukewarm improvement in political ties with Lebanon. Arrivals from Saudi Arabia doubled to 19,630 visitors through April, but remain at just 41% of their peak for the period in 2010.

Nevertheless, the small pick-up in Saudi visitors helped lift tourist spending by 8% yoy in the first quarter of 2017, its biggest improvement in two years, according to tax refund data by Global Blue. Spending by Saudi residents contributed to an estimated 16% of total tourist expenditures during the period, the single largest foreign spending group. Flynas, a Saudi low-cost carrier, is expected to resume daily flights to Beirut in October, boding well for arrivals from the Kingdom.

The tourism sector’s direct contribution to GDP is projected to grow by 2.9% to \$3.4bn in 2017, according to the World Travel and Tourism Council. Employment in the sector, however, is seen growing by just 0.1% during the year, directly supporting 123,623 jobs, close to 7% of total employment in the country.

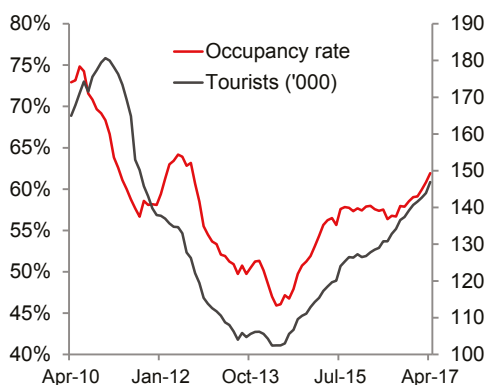
**Saudi arrivals (Jan-Apr, '000)**



Source: MoT, Economena, SGBL Research

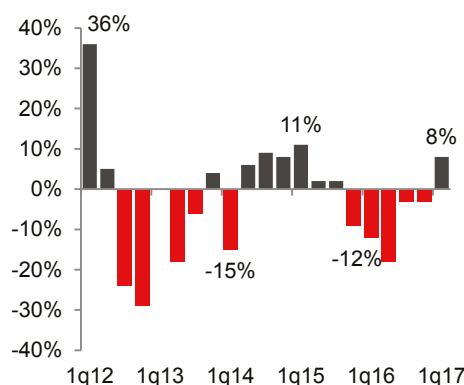
Spending by Saudi residents contributed to an estimated 16% of total tourist expenditures in the first quarter of 2017.

**Tourism indicators (12-month moving average)**



Source: EY, MoT, Economena, SGBL Research

**Tourist spending (%yoy)**



Source: Global Blue, Economena, SGBL Research

## PROFIT GROWTH AT ALPHA BANKS SLOWED IN Q1 2017

- Net profits rose by 1.7% to \$518.5m in the first quarter of 2017
- Provisions surged in line with Central Bank requirements
- Banking groups are shedding foreign subsidiaries

Net profits at Lebanon's Alpha Group banks, the 14 lenders with more than \$2bn in deposits, inched up by 1.7% yoy to \$518.5m in the first quarter of 2017, according to data compiled by Bankdata Financial Services. Profits from abroad plunged by 11.3% yoy to \$103.8m, after several banks wrote off their investments or deconsolidated their subsidiaries in Syria, Sudan, and Armenia.

Domestically, profits increased by 5.5% yoy to \$414.7m in the first quarter of 2017, broadly in line with their pace in the same period of 2016. However, domestic results were more divergent at the start of this year, with half of the 14 largest banks by deposits reporting a drop in their domestic net profit, up from just three in the first quarter of 2016.

Lending activity slowed dramatically during the period with banks effectively hoarding cash to take advantage of any possible future rounds of financial engineering by the Central Bank. Loans and advances grew by 0.7% yoy to \$64.7bn at end of March 2017, compared with growth of 8.5% yoy over the same period in 2016. At 3% yoy, loan growth in the domestic market was more robust, but remained well below its pace of 7.9% yoy in Q1 2016.

On the other hand, deposits from customers increased by 5.4% yoy to \$176.2bn, driven by an increased appetite among banks for foreign currency deposits. The latter grew by 6.1% yoy to \$123.4bn through March, while local currency deposits inched up by 3.7% yoy over the same period, 1.9% less than the average interest rate on deposits in Lebanese Pound, a sign of rising dollarization rates.

### IMPACT FROM CENTRAL BANK SWAP OPERATIONS

Collective provisions surged by 31.7% yoy to \$1bn in the first quarter of 2017, equivalent to an additional \$241m in collective provisions during the period, in line with instructions issued by the Central Bank in late 2016.

Similarly, total provisions for risks and charges jumped by 91.9% yoy or \$620.1m to \$1.3bn in the first three months of the year.

The Central Bank required banks participating in the swap operations to allocate a portion of their exceptional revenues towards increasing their collective provisions by 2% of their risk-weighted loans, and towards meeting provisioning requirements under IFRS 9.

Banque du Liban also instructed banks to use their exceptional gains for any impairment of goodwill or of investments abroad, which would otherwise have weighed heavily on banks' performance. The remaining amounts would be added to banks' Tier I and Tier II capital as reserves or deferred liabilities respectively.

At least one Alpha Group bank used the exceptional gains to write off investments in Syria and Sudan, while others opted to deconsolidate their subsidiaries in the same two countries as well as in Armenia, in a bid to minimize the impact on Lebanese banking groups from investments in foreign markets.

Foreign assets of Alpha banks declined by 5.6% yoy to \$36.8bn through March 2017, and their share of total assets fell to 16.8% from 19.2% in March 2016. The number of branches abroad also fell as a result of write offs and deconsolidation, leaving Alpha Group banks with 120 branches outside Lebanon down from 138 branches in March 2016. Total headcount moved in lockstep with branch count, falling by 0.5% yoy to 30,771 staff at the end of the first quarter.

### RISING COSTS AHEAD

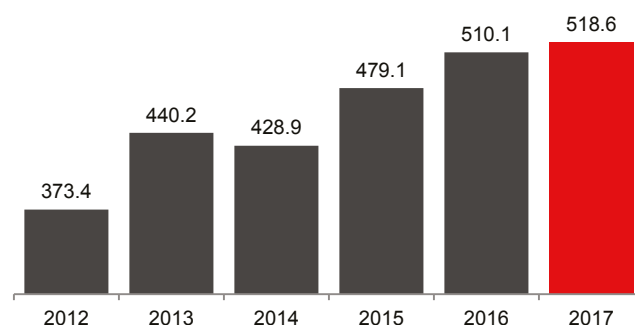
The recent uptick in deposit dollarization rates is likely to put more pressure on profit margins at banks in the foreseeable future. The average interest rate on US Dollar deposits reached 3.57% at the end of April 2017, 31 basis points more than in April 2016, while rates on local currency rates have remained largely unchanged. Expectations of continued policy unwinding in the United States will also serve to increase competition for US Dollar liquidity, adding to the cost of attracting non-resident deposits into Lebanon in the near term.

### Alpha Group, Q1 2017

	Assets (\$bn)	Net Profit (\$m)
BLOM Bank	30.14	112.03
Bank Audi	43.92	110.20
Bank of Beirut	16.92	50.24
SGBL	19.28	41.91
Fransabank	21.09	38.58
BankMed	16.83	35.89
BLF	12.61	32.15
Byblos Bank	21.28	28.74
IBL Bank	6.87	20.65
Credit Libanais	10.74	18.48
BBAC	6.71	14.30
First National Bank	4.50	7.11
Lebanon and Gulf Bank	4.16	5.74
Creditbank	3.73	2.50
<b>Alpha Group</b>	<b>218.78</b>	<b>518.50</b>

Source: Bankdata Financial Services, Economena, SGBL Research

### Net profits at Alpha Group banks (Q1, \$m)



Source: Bankdata Financial Services, Economena, SGBL Research

**LATEST DATA**

Key indicators	Unit	2016	Mar-17	Apr-17	May-17	%Y/Y	YTD	PYTD
Cleared cheques	\$bn	68.14	6.18	5.34	n.a.	-4.96	22.44	22.58
Real estate transactions	\$bn	8.48	1.07	0.73	0.75	22.92	3.82	3.43
Construction permits	Sqm, m	12.23	1.27	0.97	1.29	29.80	5.43	5.33
Cement deliveries	Tons, m	5.27	0.42	0.44	n.a.	-14.23	1.51	1.59
Tourist arrivals	m	1.69	0.13	0.16	n.a.	29.57	0.50	0.43
Airport traffic	m	7.61	0.52	0.72	0.60	-2.80	2.84	2.70
Balance of payments	\$bn	1.24	0.05	-0.32	n.a.	25.89	0.23	-0.90
Money supply: M3	\$bn	132.80	134.27	135.24	n.a.	8.09	2.44	1.49
BSE volumes	m	120.47	2.87	5.42	18.56	320.80	34.00	41.40
Passenger car sales		36,326	3,136	2,536	3,182	0.54	13,836	14,264
Hotel occupancy (average)	%	58.98	62	69	70	4.00	64.84	56.94

Indices	Unit	2016	Mar-17	Apr-17	May-17	%Y/Y	%YTD
Consumer Confidence Index - ARA		113.83	111.00	104.00	106.00	-5.36	-35.37
Consumer Price Index		96.24	99.66	99.77	99.72	4.29	0.80
Purchasing Managers' Index		45.68	46.90	47.50	46.60	4.02	-0.85
BdL Coincident Indicator		289.54	306.20	317.60	n.a.	6.58	8.69

Trade	Unit	2016	Feb-17	Mar-17	Apr-17	%Y/Y	YTD	PYTD
Imports	\$bn	18.71	1.65	1.70	1.41	-12.20	6.36	6.23
Exports	\$bn	2.98	0.23	0.27	0.24	-0.13	0.97	0.87
Trade balance	\$bn	-15.73	-1.42	-1.42	-1.18	-14.27	-5.40	-5.36
Port of Beirut volumes	TEUs, m	1.15	0.09	0.10	0.10	-6.12	0.39	0.38

Financial and monetary	Unit	2016	Feb-17	Mar-17	Apr-17	%Y/Y	YTD	%YTD
Commercial bank assets	\$bn	204.31	204.93	205.76	206.13	9.69	1.82	0.89
Claims on the resident private sector	\$bn	51.04	51.05	51.20	51.53	5.77	0.49	0.97
Claims on the non-resident private sector	\$bn	6.14	5.96	5.98	6.05	-6.55	-0.09	-1.44
Claims on the public sector	\$bn	34.72	36.41	37.75	37.39	-2.24	2.67	7.70
Resident private sector deposits	\$bn	128.53	129.70	130.14	130.93	8.03	2.40	1.86
<i>Dollarization rate (average)</i>	%	59.36	60.36	60.65	60.90	1.70	60.56	1.03
Non-resident private sector deposits	\$bn	33.96	34.16	34.21	34.55	8.92	0.59	1.75
<i>Dollarization rate (average)</i>	%	86.12	86.96	87.00	87.12	1.26	86.95	1.01
Private sector deposits with commercial banks	\$bn	162.49	163.86	164.35	165.48	8.21	2.99	1.84
Private loans / deposits	%	40.23	39.36	39.34	39.36	-0.84	39.38	0.98
Public sector deposits	\$bn	9.46	10.26	10.93	10.58	15.85	1.12	11.81
BdL foreign assets	\$bn	44.73	46.99	45.37	45.21	5.76	0.48	1.07
BSE market capitalization	\$bn	11.90	12.38	12.47	11.77	6.51	-0.14	-1.14
Gross public debt	\$bn	74.89	76.15	77.18	76.92	7.31	2.04	2.72

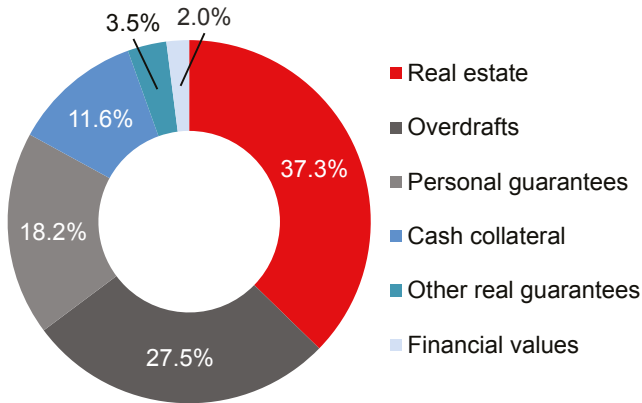
Public finance	Unit	2015	Oct-16	Nov-16	Dec-16	%Y/Y	YTD	PYTD
Revenues	\$bn	9.58	0.93	0.66	0.81	15.25	9.92	9.58
<i>Value Added Tax</i>	\$bn	2.10	0.33	0.11	0.11	9.58	2.15	2.10
<i>Telecommunications</i>	\$bn	1.23	0.10	0.09	0.19	182.89	1.27	1.23
<i>Income taxes</i>	\$bn	1.92	0.16	0.07	0.08	11.61	2.00	1.92
<i>Customs taxes</i>	\$bn	1.37	0.13	0.12	0.12	5.37	1.40	1.37
Expenditures	\$bn	13.53	1.11	1.74	1.35	-4.62	14.87	13.53
<i>Transfers to EdL</i>	\$bn	1.14	0.08	0.11	0.11	34.25	0.93	1.14
<i>Debt service</i>	\$bn	4.46	0.43	0.62	0.39	10.30	4.77	4.46
Primary balance	\$bn	0.72	0.27	-0.41	-0.14	-59.26	0.02	0.72
Fiscal balance	\$bn	-3.95	-0.18	1.08	-0.54	-24.15	-2.79	-3.95

YTD: year-to-date, PYTD: previous year-to-date. Source: MoF, BdL, BSE, ARA, Customs, Markit, EY, RHIA, CAS, Economena, SGBL Research

## KEY TRENDS

### Utilized credit by type of guarantee (December 2016)

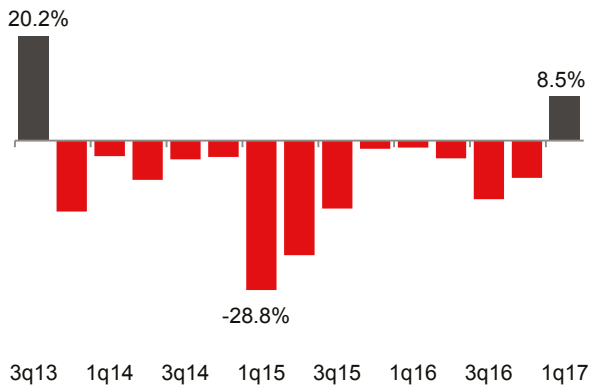
Real estate made up 37.3% of guarantees for utilized credit at the end of 2016, up from 35.1% a year earlier, a growing exposure by banks to the property market. On the other hand, cash guarantees made up 11.6% of the total, down from 12.4% in 2015.



Source: BdL, Economena, SGBL Research

### Wholesale trade of construction materials (%yoy)

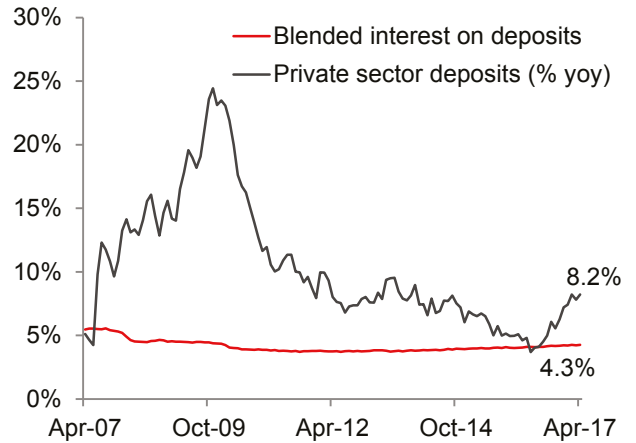
Wholesale trade of construction materials increased by 8.5% yoy in the first quarter of 2017, data by the Beirut Traders Association showed. Improving sales of construction materials indicate a pick in construction activity at the start of the year after almost four years in decline.



Source: BTA, Economena, SGBL Research

### Bank deposits and interest rates

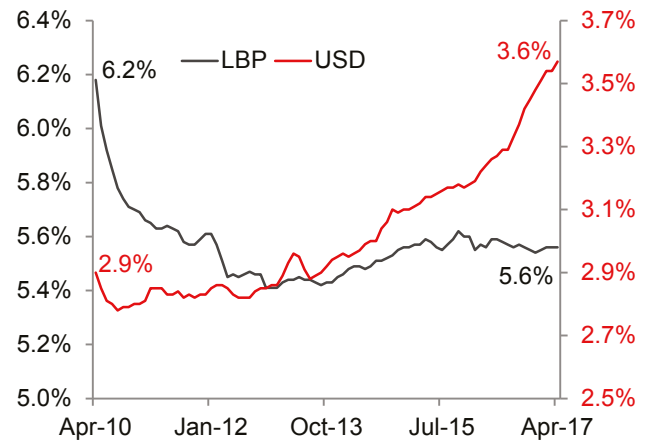
Growth in private sector deposits accelerated to 8.2% yoy by April 2017, nearly double the blended interest rate on deposits for the period. Bank deposit growth had dipped below the average interest rate in April 2016, reflecting a net outflow of deposits from the banking system.



Source: BdL, ABL, Economena, SGBL Research

### Average interest rates on deposits by currency

Interest rates on dollar deposits reached 3.6% by April 2017, up 31 basis points over the previous 12 months, while local currency rates remained stable at 5.6%. As a result, spreads tightened to a two-decade low of 2%, making the local currency less attractive to depositors.



Source: BdL, ABL, Economena, SGBL Research

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