

# Emerging Markets Debt

## Lebanon - Triumvirate of crises in one year

In this article we look at how Lebanon's bond default and potential restructure is becoming a challenge; a result of three "crises" overlapping, and how the complexity of the political circumstances make the situation all the more challenging.

Lebanon has been facing an economic and political crisis since a proposed Whatsapp tax (tax on voice calls) triggered street protests in October 2019, and eventually led to government resignation. A new technocrat government followed and the IMF were invited to begin negotiations on a support package. However, any positive momentum was negated by the Covid-19 crisis and soon after, Lebanon defaulted on their payment of the 9 March 2020 bond maturity. The problems were compounded when a massive explosion ripped through Beirut's port in August 2020 - shortly after, the Government was forced to resign.

The economic woes of Lebanon are now a humanitarian one and the country is now even more dependent on international support than before. This triumvirate of crises developed over the last year have also added to the uncertainty around Lebanon's bond restructuring. The key impediment to the Lebanese recovery however, is a fractured political system that blocks reform and international aid.

### Politics

The road to recovery in Lebanon is dependent on implementing a truly "reformist" government. Such an "ideal" government would replace the old political guard with technically competent ministers, gaining the confidence of the people, allowing tough reforms to be implemented and fully unlocking international aid and IMF support.

The key actors in how the political process will play out over the next few critical years are:

- **Parliament:** there are two main factions in parliament: the March 8 and March 14 alliances. Broadly speaking they represent pro-Iran and pro-West factions respectively. At the moment the March 8 alliance holds a majority.
- **Prime Minister:** is appointed by the President and is responsible for cabinet formation including appointment of the Finance Minister.
- **The "street":** is a term coined to represent the new wave of political activism and protests that have considerable influence. The demographics of the protestors encompasses the young, professional and are both men and women.
- **Iran:** backed parties (e.g. Hezbollah) wield considerable political influence and are an impediment to international engagement.
- **International:** the international community can apply pressure through economic support and sanctions and prefers stability in the region.

The complex interplay between these actors makes it almost impossible to predict likely changes and their timeline.

### Parliament - Deadlocked

The current parliamentary makeup is along sectarian lines and the political establishment is incentivised to maintain the status quo and their system of political patronage and privilege. President Aoun (part of March 8 alliance) represents this resistance to change, for example he has already rejected calls for early elections, rejected an international enquiry into the port explosion and has a confrontational relationship with the "street". Therefore the current parliament is, to put it lightly, resistant to change and it will be difficult to hold new elections before the next scheduled date in 2022.

### Government - Hostage to political system

After the October 2019 protests Hassan Diab was chosen to be Prime Minister but he was forced to resign after the port explosion in August 2020. This was due to political horse-trading rather than pressure from protesters. A new Prime Minister, Mustapha Adib, was reportedly closer to various political factions than Diab and he was asked to form a new government. But Shia parties insisted on control of the finance ministry and in recent weeks Adib has also resigned. This illustrates how the government is severely curtailed by sectarian affiliations, is hostage to background politics and still linked to perceived incompetent and corrupt practices. Therefore the government is somewhat hamstrung until there is some sort of parliamentary power shift or electoral reform.

### The "Street" - The key to change

Clearly the people most impacted by the crises are the people of Lebanon, where a sharp depreciation in the Lebanese Pound (LBP), risks of hyperinflation and shortages of essential goods has caused significant public anger. The experience of the Arab Spring, in the early 2010's, has shown that protests can be a catalyst of major change. However the "street" in Lebanon has no clear set of aims except to bring down the parliament and government and install a technocrat government. But they are potentially the only group who can apply the necessary pressure leading to a proper reform of electoral law. The Covid-19 crisis and port explosion have temporarily slowed down protests. The current economic and humanitarian crises are likely to be the catalyst for street protests again as the full implications of the explosion are realised.

## Iran – Barrier to international engagement but pragmatic

Iran wields significant political influence - mainly through Hezbollah. Hezbollah is a barrier to international engagement given their links with Iran and its designation as a terrorist organisation. The US has announced potential sanctions on lower ranking Hezbollah officials. However Hezbollah has shown itself to be pragmatic in the face of previous Lebanese crises and acted on the basis of political expediency rather than dogmatic beliefs. At present they are taking a measured approach to politics while still safeguarding their interests. They recognise that an overly aggressive stance would only alienate international donors and exacerbate the economic crisis and their popularity. Looking forward, a new US administration that is less hawkish and more willing to negotiate with Iran may also improve the political dynamics in Lebanon. However stricter sanctions on key political leaders may lead to Hezbollah taking a more aggressive stance.

## International – Hold the keys to financial aid

To date the international community has pledged \$300m in financial aid, which falls woefully short of the economic damage caused by the port explosion. Aid is being directed through NGO's and not through the government as perceptions of corruption are high. International aid is also linked to IMF engagement and both need to be secured.

President Macron has taken the lead for the international community and has visited Beirut twice after the port explosion and is scheduled to return in December. France has been pushing for a technocratic government that can quickly tackle Lebanon's pressing reforms. Macron, in a flurry of activity, has personally mediated a broad range of Lebanese political factions (including Hezbollah) and simultaneously coordinating the international community (including Iran and Russia). However he had to backtrack on his calls for early elections and change of electoral law. There were early signs of a positive engagement by Macron but the failure of the latest PM highlights the difficulties. Especially as Macron and Lebanon's traditional backers in the Gulf Cooperation Council (GCC) have sent a strong message that there need to be tangible reform results before international aid is forthcoming.

## What will actually happen?

The complexity of the political arena makes any prediction difficult to make. However it is likely that the political class will try to implement the minimum number of reforms that would appease the international community in the short term and stabilise international relations. This would at least provide temporary relief but does not come close to addressing their problems. Parliamentary sectarian factions and vested interest still act as a barrier to progress. Unfortunately therefore the situation may need to get worse before it gets better. The port explosion has galvanised the public and there is the beginnings of a coordinated front between protest groups, civil society groups and political parties as they announced a unified political platform on 30 August.

Increased FX (foreign exchange) volatility in parallel markets has been forcing prices up and led to severe shortages of petrol, medicine and bread. This will be a key factor in the short/medium term as only significant and concerted pressure from the street and the international community will be the catalyst for the change required. Longer term, elections being brought forward to 2020 might give the time for reformers to organise themselves to win

elections and push through reforms in parliament, but two years is a long time for Lebanon and it is difficult to see how it can muddle through until then.

The uncertainty and complexity inherent in politics is priced into bonds that are at a cash price of approximately 20 cents.

## Fiscal/Monetary/External

Given the effective collapse of the Lebanese economy, the three economic factors can now effectively be considered as one as the external and government liabilities need to be addressed as one, and the Central Bank is deeply enmeshed in the financial system. Like many economic crises, the Lebanese economic crisis was triggered by a shock to the external accounts. Lebanon has a structural current account deficit due to the legacy of a pegged currency and an economy heavily reliant on imports. The external account was funded by ex-pat remittances being deposited in the Lebanese banking system attracted by high interest rates. This system relied on confidence in the Central Bank to maintain the pegged Lebanese Pound, and a banking system that could attract constantly growing and continued remittances inflows.

However, as confidence waned, debt/GDP also increased sharply to 150%+ and Central Bank FX reserves started to be run down. The final shock to confidence came when street protests forced banks to close. The Lebanese Pound has depreciated by approximately 80% causing inflation to spike but also severely curtailing imports and relieving pressure on the current account.

The Rapid Damage and Needs Assessment (RDNA) is an investigation carried out by the World Bank specifically on the impact of the port explosion. It estimates damages of US\$3.8-4.6bn (7.1-8.6% of 2019e GDP), and economic losses of US\$2.9-3.5bn (5.4-6.6% of 2019e GDP). It also estimates that the loss of GDP due to the explosion for 2020 and 2021 will be 0.8% and 1.9% respectively. In the scenario we expect where international aid is linked to a structural reform, an IMF program and reconstruction this may result in improved confidence, growth and debt recovery prospects and help the country on a more sustainable path. In the absence of external support the government's ability to service debt is likely to be reduced and therefore stricter haircuts and coupon adjustments might be imposed on the recovery of the defaulted bonds.

## Restructuring outcome

Lebanon bond prices have stayed in a tight 16 to 19 (cents, USD) range since the start of the Covid-19 crisis in March. Therefore the port explosion and subsequent change in government had limited impact on bond prices. Despite the weak fundamentals and complicated political picture, bonds have found a floor here as downward pressure on bonds is limited because much of the selling has already occurred as Lebanon is now a relatively small part of the JPM EMBI benchmark.

We believe that Lebanon will be able to negotiate a five year grace period on interest on the restructured bonds and thereafter the reduction of the coupon to the minimum level as per IMF guidelines. But our estimate of recovery value is now only 17 to 20 (cents, USD) as a significant haircut will also be needed. There is clearly a downside risk of more political paralysis but unlike Venezuela, there is significant influence from Western governments and the GCC, and public protests are effective in holding politicians to account.

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