Lebanon:
Rolling with the punches

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- **Lebanese protesters are threatening the government over the state of the economy. Our baseline is that the government may resign, leading to another power vacuum. While the country is no stranger to political vacuums, repercussions on economic and social policy are not to be discounted.**
- **While the historical reform track record remains mixed, even partial reform implementation could support the disbursement of some donor funds, especially within the context of stabilising the country.**
- **Local security developments will continue to subdue the real economy. Tourism is robust, but insufficient to compensate for a deteriorating fiscal position.**

Fury grows despite 11th hour plan

The protests that started on 17 October did not come out of thin air. They reflect a loss of faith in the current government among many Lebanese due to the worsening financial crisis and government mismanagement. We see three scenarios:

- A best-case would see new elections bringing forth fresh blood and a new vision for the country.
  - In his speech announcing a new economic reform package, Prime Minister Saad Hariri said that if the protesters want an early election, he would back them. But it would then be up to the protesters to select new candidates.
  - Even in such a situation, however, protest candidates would be faced with the sectarian character of Lebanon's electoral law, written by the parties they seek to depose, and a cabinet selection process that requires consensus from various religious groupings.
- The worst-case scenario sees the protests heating up, especially if the government refuses to resign, reigniting sectarian tensions among protesters.
- If, per our baseline scenario, the government were to resign, there would most likely be another power vacuum.
  - For example, it took Hariri a year to form the current cabinet.
  - Such situations are far from bracing, but nothing new in Lebanon. Previous vacuums have not destabilised the country, although they have imperilled the policy making process.
  - Repercussions on economic and social policy are not to be discounted.

The protesters have made one thing clear -- they blame the entire political class for the current state of affairs and want it to go. The government has responded by trying to ease the economic situation.

Table 1 – Lebanon Macroeconomic Indicators[1]

	2016	2017	2018	2019e	2020f
Real GDP Growth (%)	1.7	1.5	0.3	0.2	2.0
CPI Inflation (%)	-0.8	4.5	6.1	2.0	2.3
Fiscal Balance (% of GDP)	-8.8	-6.0	-9.7	-7.0	-11.0
C/A Balance (% of GDP)	-23.1	-25.7	-27.0	-28.2	-28.4
Total Gov't. Gross Debt (% of GDP)	146.1	149.0	150.9	157.8	162.7
Total Gross Extrn'l Debt (% of GDP)	182.0	183.1	184.7	191.3	199.4
Gross Official Reserves Ex. Gold (Mos. of Imports)	14.9	13.9	12.0	10.6	10.1
Nominal GDP (USD B)	51.5	54.2	56.7	58.3	60.6
Population (Millions)	6.7	6.8	6.8	6.8	6.8

- It has scrapped a proposed USD 6 tax on Voice Over Internet Calls (such as WhatsApp) following the outbreak of the demonstrations.
  - This may seem small, but such austerity measures have infuriated ordinary Lebanese and brought focus on the wider issues the country suffers from.
- Other unpopular austerity measures remain, such as a plan to cut civil servants' salaries by half, as well as imposing major reforms of state institutions to streamline costs.
- Lebanon has now committed to reducing its deficit -- estimated last year at 9.7% of GDP and this year at 11% of GDP -- to 0.6% of GDP in 2020, versus a 1% annual reduction proposed over the next five years to unlock the CEDRE donor funds.
  - In the past five years, the fiscal deficit averaged 7.5% compared with a 10-year average of 4.8%.
  - Proposed new reform measures are highly unlikely to produce a zero-budget deficit, given the high level of debt to GDP ratio & high level of interest rates (average of 7%).
    - The debt-to-GDP ratio stands at a 10-year high of 150% but remains below the all-time peak of 183% in 2006. Lebanon's debt-to-GDP ratio is the third highest globally, after Japan and Greece. Unemployment is close to 25%.
    - Sovereign credit ratings reflect the challenges faced by Lebanon. Moody's downgraded Lebanon from B2 to B3 in August 2017, while Fitch and S&P have maintained their ratings at B-/B3 equivalent. All are "junk" status.
- To boost revenues and reduce state spending, reforms proposed include an overhaul of the costly electricity sector. Subsidies for state-run Electricité du Liban (EdL), currently estimated at about USD 2B annually.
    - This poses a huge challenge to the new government. Despite the subsidies, EdL does not generate enough electricity to provide 24-hour power, and blackouts are common.
    - EdL has been making a loss for years as the price that is charged to customers is well under unit costs.
    - No government has yet been willing to take the politically unpopular move of increasing electricity bills at a company that is seen among the public as incapable of providing adequate power.

[1] Arabia Monitor; IMF.

- Other measures include:
  - The abolition of state institutions such as the Ministry of Information;
  - Cutting the budget of the development and construction agency by 70%;
  - The privatisation of telecommunications;
  - Reforming the state-run power sector by speeding up licensing for power plants;
  - Contributions of USD 3.4B from banks;
  - Establishing an anti-corruption committee by the end of the year;
  - Social policy reform including the providing an additional USD 13.3M to a programme that supports poor families, and;
  - Providing USD 160M to back housing loans.
- Initial reactions to the 2020 state budget and economic reforms were angry, prompting hundreds of thousands of protesters to take to the streets across the country. Demonstrators in Beirut's Martyrs' Square were infuriated that Hariri seemed to dismiss their demands.

Worsening economic crisis

The protests are driven by the worsening financial crisis, the government's perceived double-dealing and mismanagement, and the recent new tax reforms propositions aimed at narrowing the distressed budget deficit.

- The unprecedented eruption of fire forests in the Western Mountains of Lebanon topped off the rage as the government response was seen as inadequate, relying on international support.
- The unsustainable public debt has also led to a parallel market setting higher foreign exchange rates as US dollar shortage.
  - Implications from this were felt in the wheat market, threatening national bread storage due to lower wheat imports as suppliers became unable to meet the high exchange rate of the dollar for purchases.
- The current protests are, however, non-sectarian in nature, which is unusual for Lebanon.
  - The scope of the protest is much wider than usual, encompassing the Beqaa, Tripoli, Nabatiyeh, Tyre and Zouk, and mobilising huge numbers.
  - Lebanese citizens from all walks of life have been taking to the streets, making the transcend not only sectarian lines but also class.

The IMF revised growth to 0.2% for 2019 in October, down from the 1.4% projected in July and more in line with the 0.3% in 2018. Such growth remains below potential when compared with the average of 4.5% for 2000-14.

- Low growth, plus the protests, mean that global investors are getting more nervous about Lebanon's ability to fix its financial situation. CDS spreads were up 87 bps to 1,262, the highest level on a closing basis since the start of the month, after the protests erupted, but they have a history of bouncing back quickly.

Table 2 – Credit Ratings Comparison[2]

	Egypt	Morocco	Lebanon	Turkey	Tunisia
Moody's	B2 Stable	Ba1 Stable	Caa1 (Under review)	Ba1 Negative	B2 Negative
S&P	B Stable	BBB Stable	B- Negative	B+ Stable	NR
Fitch	B+ Positive	BBB- Stable	CCC Stable	BB- Negative	B+ Negative

  - For comparison, after the assassination of then-Prime Minister Rafic Hariri on 14 February 2005, spreads widened by about 90 bps to over 400 bps over US treasuries. Confidence started to strengthen again with the appointment a few months later of Najib Mikati to be new prime minister. Spreads narrowed to 246 basis points by year-end.
  - When the July-August 2006 war broke out, spreads widened by nearly 200 bps to more than 600 bps. Eurobond spreads stood at 492 bps in September, after the war, or 120 basis points higher than in mid-July, before the conflict.
  - Admittedly, these two episodes above, saw CDS widening from much lower bases compared with today. This time could be different. What is certainly different this time is that GCC states have not rushed to the rescue the way they could afford to do in the past.
- Data in general has been poor. The number of new construction permits fell 15% during the first eight months of the year, while cement deliveries fell over 30%.
- Real estate transactions in the first nine months declined by 15% YoY to 36,952 transactions.
- New car sales continued to drop due to the severe economic slowdown and to high interest rates imposed on car loans.
  - According to figures released by the Association of Automobile Importers in Lebanon, 19,865 new passenger cars were sold in the first nine months of 2019, 24% lower than the same period last year.
- The only bright spot has been tourism, but this is not enough to balance out the other macro vulnerabilities.
  - Overall, tourist arrivals grew by 8.3% YoY in H1 to 923,820.
  - Continuing protests will put off many tourists.
- The IMF expects inflation to decline to 2% in 2019 from 6.1% in 2018.
  - But price pressures linger from the rise in the cost of oil imports and the weakening of the US dollar to which the Lebanese pound is pegged.
  - Inflation averaged 1% in the last 5 years compared to a 10-year average of 3.7%. In the shock years of 2005 and 2006, inflation averaged -0.7% and 5.6% respectively.

[2] Arabia Monitor; Moody's; S&P; Fitch.

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