Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

By Patrick Fearon-Hernandez, CFA

December 2, 2019

Lebanon and its "Revolution of the Millennials"

Working at NATO Headquarters in Brussels in the 1990s was a diverse experience: my coworker was Belgian, my boss was British, his boss was French and our secretary was Turkish. But what felt especially exotic were my weekends in eastern Belgium, on the Dutch border, with my Turkish, Egyptian and Lebanese friends. Many nights were spent in the clubs of Liège, Leuven and Maastricht! I wonder how much hearing I lost to the throbbing beat of Eurotech and World Pop. There I got my first taste of flamenco-rock and the intoxicating, wavering Arabic stars like Lebanon's Haifa Wehbe. It felt like I was reliving Beirut in its heyday.

But that Beirut was already gone, destroyed by Lebanon's 1975-1990 civil war. My Lebanese friends were refugees who might never go home. Although a fragile peace may have been put into place, the country was not healed. And now, throughout the autumn of 2019, mass political protests have paralyzed the country and highlighted its continuing problems. In this report, we'll explain what's behind the turmoil and why it may continue. As always, we'll conclude with the ramifications for investors.

Multi-ethnic and Multi-religious

Many Westerners seem to assume that Islamic countries are invariably conservative, xenophobic and repressive, but the reality is that Islamic societies throughout history have often been diverse and tolerant. A prime example is the Moorish kingdom on the Iberian Peninsula from 711 to about 1000, which was built on Islamic, Jewish and Christian communities. Occupying a key trade route between southeastern Europe and the Middle East, the Lebanese have historically been open and tolerant as well. As shown in the Bible, the ancient Canaanites in the area had extensive contact with outside groups (including the Israelites, who were often at war with them). Their descendants, the Phoenicians, had a great seafaring and trading culture that established colonies as far away as Tunisia and Spain.

The area that is now Lebanon, along with Syria and much of Anatolia, became a major center of Christianity during the Roman Empire. Adhering to the ascetic teachings of a hermit named Maron, the Maronite Christians retreated to the Lebanese mountains to escape Roman persecution. After the Muslim Arabs conquered the area in the 600s, Islam gradually began to gain influence, but the relatively isolated Maronites were able to retain much of their autonomy and culture. Because of the temporary establishment of Crusader states in the area during the 1000s, the Maronites pledged their allegiance to the Roman Catholic Church and formed a particularly close bond with France. Also in the 1000s, an offshoot of Shiite Islam called the Druze faith took root in the southern area of modern-day Lebanon. To this day, Lebanese society remains divided among Christians, Sunni Muslims and Shiite (Druze) Muslims.

Lebanon was part of the Ottoman Empire for some 400 years until the empire was dismantled at the end of World War I. It was then controlled by France until it became independent following World War II. The key domestic political problem then was how to reconcile the aspirations and interests of Lebanon's various Christian and Muslim populations. The solution was a "confessionalist" power-sharing pact in which specific government posts were guaranteed to certain religions. For example, Lebanon's president is always a Christian, while its prime minister is a Sunni Muslim and its speaker of parliament is a Shiite (Druze) Muslim. Parliamentary seats were doled out based on each religion's relative weight in a 1932 census.

The "National Pact" system helped keep the peace in Lebanon for nearly 30 years. With its strong commercial culture and advantageous location, the country prospered. Tourism, agriculture, international trade and banking all thrived. Eventually, however, Lebanon's delicate religious balance began to wobble due to the rapid growth of the relatively poorer Muslim population, which not only had a high birth rate but was also being bolstered by refugees from the Israeli-Palestinian conflict. The fast-growing, increasingly radicalized Muslim population began to feel it was underrepresented, and civil war broke out in 1975. As it raged for the next 15 years, the war devastated the economy and virtually destroyed Beirut. It also opened the door to foreign meddling that continues to this day. For one thing, the war prompted the Syrian government to send in troops, ostensibly to maintain order but also to exploit Lebanon for its own purposes. After Israel occupied southern Lebanon to stop Palestinian rocket attacks on it, the Shiite resistance movement Hezbollah introduced Iranian influence into Lebanon. The war pushed tens of thousands of Lebanese into exile, including many of those I met in Brussels.

The Delicate Peace

The Lebanese civil war was eventually brought to an end by the Ta'if Accords of 1989, which tweaked the confessionalist system to give the Muslims modestly more power but otherwise left the system basically unchanged. Lebanon's current political and economic problems aren't necessarily the result of the *allocation* of power. Rather, they are just as much the result of the *guarantee* of power. One major problem is that the static division of government has spawned an extensive patronage system, where each party has a lock on certain jobs and doles them out to its supporters. In a country like Lebanon, where the government is among the biggest employers, that confines the labor market and makes it very difficult to find a job. Youth unemployment is especially rampant. Guaranteed power and the lack of any accountability for failure have also spawned endemic corruption, poor public services and environmental degradation.

Lebanon has developed a political system in which no one wants to upset the apple cart. None of the political parties has an interest in cutting the government's bloated payroll or public spending. Lebanon therefore has a large, perennial fiscal deficit, which over time has driven debt and debt-service costs higher (see Figures 1 and 2). Lebanon's total gross public sector debt stands at approximately 151% of gross domestic product (GDP), far exceeding the typical debt burden among less-developed countries. To make matters worse, nearly half of Lebanon's public debt is denominated in dollars, so its debt-service costs can increase sharply when U.S. interest rates rise and the dollar appreciates.

Figure 1.

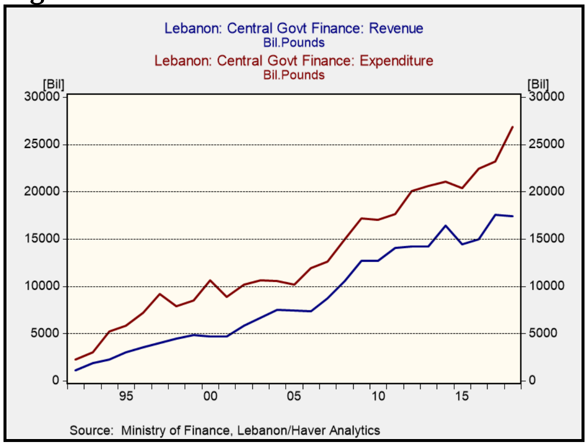
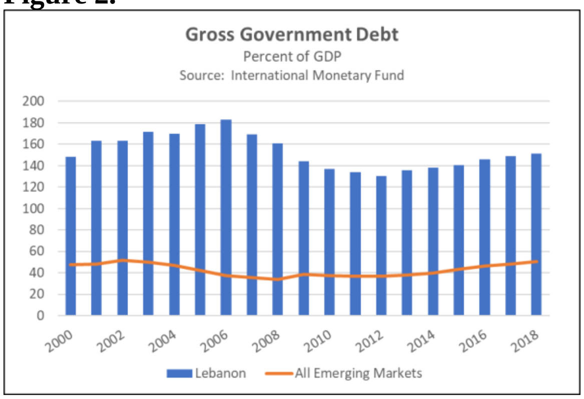
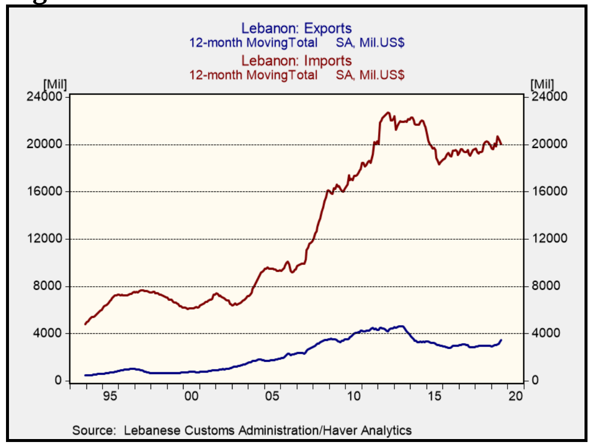


Figure 2.



Making Lebanon's situation even more tenuous, the country also suffers from a persistent trade deficit. In large part, the excess of imports over exports is the result of a currency peg that has remained at 1,507.5 Lebanese pounds per dollar since it was established in 1997. The peg has helped provide some stability to the economy but, since it has never been adjusted, the currency is now overvalued compared with what it should be. In 2018, the overvalued pound was instrumental in pushing Lebanon's merchandise trade deficit to $17 billion. The excessively strong currency helped cap the country's exports at a paltry $3 billion, while boosting imports to some $20 billion (see Figure 3).

Figure 3.

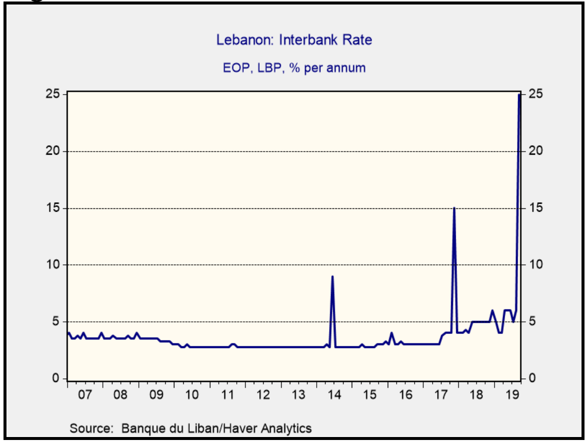


Today's Crisis

Large fiscal and trade deficits like Lebanon's would be expected to spur an outflow of foreign reserves, but the country has traditionally been able to stave off that risk with large flows of financial aid from the Gulf states and remittances from the many Lebanese living abroad. However, the country finally had to face reality this year amid disappointment over the prime minister's economic reform plans, slowing economic growth, rising U.S. interest rates and a strengthening dollar. Foreign deposits into bank accounts slowed sharply, creating a shortage of foreign exchange. Banks were forced to pay as much as 1,580 pounds per dollar and restrict their customers' access to the currency.

By early October, the government had been forced to declare a state of emergency, and the central bank implemented a special rule guaranteeing that importers of essential goods could buy dollars at the official exchange rate. The central bank also had to hike interest rates (see Figure 4). Even though Lebanon has never defaulted on its debts, major bond rating firms cut the country's foreign-currency debt rating deep into "junk" territory.

Figure 4.



The event that drove protestors into the streets was the government's ham-handed action as it realized it needed to reduce its deficit and borrowing quickly. With the political paralysis precluding any broader, more traditional reforms, the government imposed a fee on WhatsApp calls. The fee fell especially hard on Lebanon's youth – the millennial generation that was already primed for protests because of the high level of youth joblessness and lack of opportunity mentioned above as well as their awareness of the current youth-led political protests in places like Hong Kong. Although the government quickly reversed the fee, it was too late, and the protests continued to strengthen.

As it stands, the "don't upset the apple cart" nature of Lebanon's government is a key obstacle to implementing economic reforms and defusing the protests. Hezbollah and the Shiite factions as well as Christian President Auon have blocked any meaningful reforms or government reshuffle. Hezbollah has been at the forefront of this counter-revolution. Its operatives have even physically attacked the millennial protestors. Its mere participation in the government is also a stumbling block for the Gulf states to provide additional financial aid. In late October, Prime Minister Hariri resigned, complaining that he couldn't reach a compromise to improve the situation.

The main political parties will now submit candidates for a new prime minister, but there are already indications that it will be extremely difficult to find candidates sufficiently unsullied by corruption to satisfy the protestors. In response to Hariri's resignation, protestors in the streets reportedly chanted, "All of them!" As the Lebanese try to work out the succession, the country's economic and financial problems are likely to fester.

Ramifications

For Lebanon itself, today's key risk is that a loss of confidence could spur uncontrollable capital flight, a chaotic currency devaluation and a debt default. The result would likely be a sharp rise in inflation and a deep economic pullback. Although the government has been in negotiations with the International Monetary Fund for a financial assistance package, its inability to implement coherent, effective economic reforms has prevented a deal to date. A debilitating devaluation and/or debt default remains a distinct risk. The continued impasse on how to fix the economy also suggests political tensions will continue to simmer and protests could intensify, raising the possibility of religious or ethnic conflict.

More broadly, the continued unrest in Lebanon echoes the current dynamics in Iraq and many other countries. From the Middle East to Hong Kong and Latin America, the tensions reflect a population – especially the young – that is frustrated by their country's poor economy and lack of opportunity. Lebanon's millennial protestors will likely inspire likeminded protestors abroad, just as they have been inspired by protestors in places like Hong Kong. That will be especially true if the Lebanese protestors have further success in ousting corrupt or ineffective politicians. On the flip side of that coin, the unrest in Lebanon is not only undermining the country's entrenched political class, but it is also tainting Hezbollah and, by association, its benefactor Iran. Although Iran has tried for decades to build its reputation in the Middle East as a helpful protector of the masses, it is now seen as a source of foreign interference.

If Lebanon can avoid an outright currency devaluation or debt default, the global economic and financial ramifications of the crisis would likely be minimal. However, if devaluation or default happens, the main negative impact may be in souring investors on the broader asset classes of emerging market stocks and bonds. Lebanon and its debt loads are small enough that a devaluation or default by the country might barely register on the global economy. The problem is that such an event would likely reignite the recent concerns about broader emerging market finances. If a crisis in a small country like Lebanon were to spark an emerging market crisis, global risk assets would likely suffer, while safe havens like U.S. treasuries and precious metals would likely strengthen.

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