PGIM FIXED INCOME

TRIP NOTES

Dispatches from Lebanon, Jordan, and Iraq*

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Ray of Light in Lebanon?

The frustration that many Lebanese citizens feel toward their economic situation was evident upon my arrival in Beirut in late September 2019. When I told the police officer checking my passport that I was in the country on business—without specifying the industry—he replied that "we are in a severe crisis." That frustration boiled over in mid-October when a series of protests about proposed reforms and tax hikes, including one on a popular mobile messaging service, brought the country to a standstill.

As one of the world's more indebted and unequal countries in terms of wealth distribution, Lebanon requires investors' close monitoring given its 1.68% representation in J.P. Morgan's EMBI Global Diversified Index. Despite a general sense of pessimism on Lebanon's outlook, we caught some contrarian glimpses of light during our trip.

While the Lebanese public are used to living precariously, there is a realization that "this time might be different," and the need for improvement has seemingly reached critical mass. In addition to comments from the general public, nearly every official we spoke to indicated that it was time to address the fiscal situation—last year's general government deficit was 11% of GDP, much of which was attributed to interest expenses—and undertake structural reforms.

From a bondholder's perspective, economic growth is generally a prerequisite for consistently servicing external debt. For Lebanon, prospects for growing out of its deficit appear slim over the near term as estimates indicate flat or marginally negative growth in 2019 and 2020.

Muhammad al-Amin Mosque, Where Some of the Recent Demonstrations Occurred

Source: Giancarlo Perasso

** We didn't travel to Iraq, but met with various international organizations involved with Iraq that are based in Amman, Jordan.*

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As a result, the Lebanese authorities are relying on $11 billion in assistance/soft loans that multilateral institutions and donors pledged at the CEDRE conference to promote growth in Lebanon that was held in Paris about 18 months ago.[1] However, instead of explicit budgetary support, the money is slated to finance development projects, many of which would require substantial imports and wouldn't significantly increase FX reserves. Rather than IMF-style quantitative/policy criteria, the conditions attached to the $11 billion are mostly guidelines (with one important exception) that are meant to reassure the donor community that Lebanon's macroeconomic imbalances are being addressed.

The key condition to the funding is for Lebanon to reduce its government deficit/GDP ratio by about one percentage point per year. With the current deficit to GDP at 11%, it's encouraging that the authorities recognized that a reduction to only 9.5% may not go down well with donors, possibly keeping the funds frozen. Therefore, with a tax/GDP ratio of about 20% and generally low inflation that wouldn't overly exacerbate the effects of tax increases, a three-day meeting of the council of ministers was held in late September to float some proposals (another suggestion was for an increase in cigarette taxes—as equally controversial as the now-rescinded levy on the messaging app) without a major overhaul of the tax system or reductions in public sector wages.

The latest proposals include a "wealth tax" and the Banque du Liban's (BdL) new "financial engineering" operation, which is designed to have the banking sector assist in servicing the public debt. The latter is largely considered a band-aid given the country's dollar liquidity squeeze and the likelihood of negative net reserves at the BdL.[2] While the banks appear somewhat ambivalent toward the operation, we think that they will ultimately participate, if only as a way of buying the authorities more time, which they badly need.

In addition to efforts to generate tax revenue and garner support from the banking sector, another important measure in Lebanon's upcoming budgets is the imposition of a $1 billion cap on the financing to Electricite de Liban (EdL), which is losing almost $2 billion per year because electricity rates have not changed since 1994. As a result, EdL turns off its plants for a couple of hours a day, leaving households to get one-third of their electricity from private providers that charge exorbitant rates. The agreement between EdL and the government involves rate adjustments and should improve the electricity supply.

Should Lebanon's draft 2020 budget present a coherent and credible fiscal adjustment path, the donor community might be favorably disposed to release some of the aid even if the adjustment is limited. The situation remains very fluid, and parliament has yet to approve the budget.

EdL as ESG Beacon in EM

The ESG priorities in emerging market countries are often unclear, particularly in precarious economic conditions. But Electricite de Liban already produces 12% of its energy from wind and solar, and it is targeting 20%—based on a significant increase in planned capacity—by 2030.

While these renewable power plans may sound ambitious, the EdL staff we met appeared highly professional and firmly committed to the goal. Furthermore, there are strong incentives for wind and solar generation in Lebanon given that this renewable generation is already cheaper than conventional power generation.

We're keeping our fingers crossed that any future economic or structural reforms don't impede EdL's progress.

The government's need for additional time is underscored by its composition as all major parties are represented in parliament and hold 90% of the votes. Despite the government's strong majority, the parties have very different orientations, and reaching a consensus has been highly time consuming. As a result, while the country needs to take (at least) three steps forward, it may only be able to muster one at this point.

Given the backdrop of economic frustration, narrow opportunities for only slight improvements, and significant debt service costs, Lebanon appears to be a perfect case for the government, international financial institutions, donors, and private creditors to sit around a table and agree on a friendly debt restructuring in the framework of an adjustment program. Unfortunately, this scenario appears to be anathema for the Lebanese authorities, who appear are opting for the "whatever it takes" approach to servicing its debt.[3] So, while this latest trip was far from providing a bullish view on Lebanon, it perhaps shed some light on a generally pessimistic view. Change, therefore, will be gradual in a best-case scenario with the BdL aiming for (precarious) monetary and financial stability, while the macroeconomic scene slowly improves.

[1] The CEDRE Conference ("Conférence économique pour le développement, par les réformes et avec les entreprises") was sponsored by France and was held on April 6, 2018 to support Lebanese development and reforms.

[2] There is no official data on the BdL's net reserves. Its gross FX reserves, excluding gold, are around $38 billion, of which $33 billion in cash. Interestingly, we were told that the BdL values its $15 billion in gold holdings at $600 per ounce, which is far below current market prices. However, if the BdL revalued its gold stock, it would have to transfer 80% of the revaluation to the government (e.g., if it applied a price of $1,200 per ounce, it would have to transfer $12 billion to the government). Yet, the BdL is against revaluing its gold stock as a windfall into the government coffers would remove the incentive to make fiscal improvements.

[3] There are striking similarities between Buenos Aires, Argentina and Beirut, Lebanon—e.g., upscale districts, nice restaurants, busy traffic, relatively large middle class, government subsidies, and, unfortunately, shanty towns. But one significant difference remains: Lebanon has never restructured/defaulted on its debt, and it was made very clear that the authorities will take all steps to continue servicing the debt.

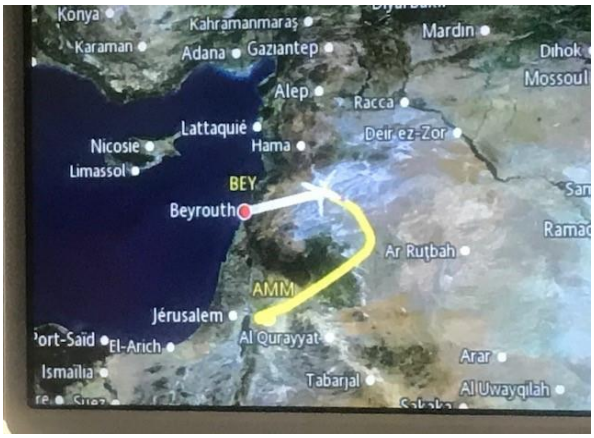
Stability and Foreign Aid Remain Paramount in Amman

Before going to Beirut, we stopped in Amman, Jordan. Jordan comprises 2.60% of J.P. Morgan's NexGem Index. After a series of meetings, we compiled our notes on board Middle East Airlines (MEA), which is owned by the Banque du Liban, on the way to Beirut. However, we didn't have too much time because this year's flight was much shorter than in years past. "MEA pilots know where to fly over Syria, other airlines' pilots don't," a Lebanese friend told me, which explains our circuitous route on Royal Jordanian airlines in 2018.

A More Direct Route into Beirut This Year

2019:

2018:



Source: Giancarlo Perasso

While our flight route from Amman changed this year, our view of Jordan's situation and outlook remained consistent, i.e., "we'll promise to do everything in order to secure foreign aid. Whether we'll actually do it is a different story."

Thus, Jordan presents a classic tale of moral hazard. King Abdullah II, who generally remains quite popular, and Jordan's allies continue taking great pains to keep the country anchored to the West given its high-tension geopolitical location. It's a situation where the conditions described below have the potential to persist for some time.

Jordan's IMF program is back on track, and its June review was immediately followed by a donor conference where assorted donors/international organizations pledged $5 billion in funding over five years. This followed a pledge of $1.2 billion by Middle East allies at a summit in Mecca, Saudi Arabia that followed the recent attacks on cargo vessels in the region. However, some initial signs of donors' restlessness with Amman have emerged as the funding mostly consisted of soft loans, rather than grants.

The current Finance Minister, who is a former World Bank staffer, is well respected within the donor community. Maintaining that relationship is crucial, and Jordan has shown a penchant for quick changes within the position. The country has had 60 Finance Ministers since 1922, some of whom served for just a few days, and the current Minister is the third in three years.

As part of the IMF's review, the Jordanian government pledged fiscal improvements and followed through with some new taxes and laws to keep teachers' salaries under control. Protesters, mostly comprised of professionals, quickly took to the streets, and the tax increases were consequently repealed. Teachers continue to protest the salary constraints. An uptick in cigarette smuggling from Syria was also cited as contributing to the revenue shortfall.

The current IMF program expires in March 2020, and officials are already working towards a new program as well as a plan to issue a $1 billion Eurobond, likely after the potential completion of the new IMF program.

Jordan's fundamentals remain weak. Its current growth is estimated in a range of 2.0-2.5%, which is way too low to absorb the rapidly growing labor force. Meanwhile, the Iraq-dividend (i.e., the opening of the border that should have facilitated the resumption of exports) has yet to materialize due to what is cited as a combination of "difficult" Iraqi regulations and customs officials as well as cheap exports from Turkey and Iran that have taken a good deal of the Jordanian export share. Ironically, Amman is seeing some construction financing from Iraqi capital (see the following Post Script on Iraq).

Jordan's debt/GDP ratio is approaching 100%, of which 15% is due to funding the national electricity company. Similar to Electricite de Liban, Jordan's National Electric Power Company is very big on renewable energy generation (mostly from solar), but rates remain low, and many customers don't pay their bills.

Upon departing Amman, our base case is that conditions within the country maintain their current course. Anxious to keep Jordan in the fold, regional allies and Western-oriented institutions will likely continue financially supporting Amman at the cost of material fundamental improvements.

Post Script on Iraq

Some of the international organizations involved in Iraq are located in Amman, so we took the opportunity for a quick debriefing on conditions in the recovering country, which comprises 3.02% of J.P. Morgan's NexGem Index.

In a nutshell, as long as oil prices stay above the area of $45 per barrel, Iraqi authorities will be able to meet their external obligations and preserve some stability within the country. Its FX reserves are estimated at $67 billion, and after last year's recession of -0.6%, growth this year should be in the +4%-5% range. However, if oil prices drop below $40, Iraq will likely approach the IMF, which would probably oblige with a new program even after the one that expired last July was pretty much a failure—only $2.7 billion out of the program's $5 billion was disbursed.

Oil revenues are vital to Iraq, and it is currently producing 4.6 million barrels per day, 3.8 mbpd of which are exported. That production and export is likely sufficient to pay for some minor capital expenditures and the salaries of 4.5 million public employees vs. its 400,000 public sector employees in 2003. This puts Iraq's current public sector wage bill at 17% of GDP, likely making it the largest public sector wage bill in the world. For reference, the public wage bills in the UK, Italy, Russia, and Lebanon are 9.5%, 10.1%, 10.9%, and 9.2%, respectively. Tunisia comes relatively close to Iraq at 14% of GDP.

Refugees are no longer going to Jordan, but Iraqi money is. Apparently, half of Amman's recent buildings have been financed by Iraqi money.

As it stands, the Iraqi government does not seem focused on tackling the country's numerous challenges. Sanitation and water availability are still major problems, while corruption and illicit enrichment remain widespread. It's a relatively subdued post script, but Iraq will likely honor its external obligations as long as oil prices remain around $45 per barrel or above.

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