



Lebanon: Hariri's assassination leaves the country on a precipice

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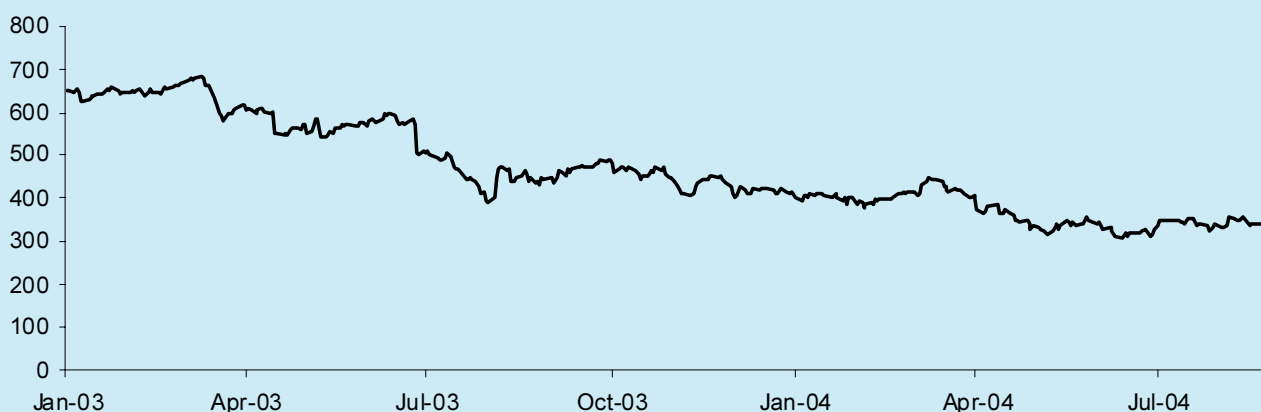
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- **The former Prime Minister, Rafik al-Hariri, was killed by a car bomb today.** The tragic death of the country's most distinguished politician has sharply raised the uncertainty about Lebanon's political future, including the outlook for May 2005 parliamentary elections and the shape of the new government, the sustainability of the Taif power-sharing accord, the scale of Syria's presence, and Lebanon's relations with the West and with the key regional powers.
- **Hariri's assassination will likely further isolate Lebanon internationally.** Saudi Arabia will be particularly upset: Hariri was their closest ally in the region. Those Western leaders who offered support to Lebanon in the past thanks to Hariri's personal effort (including President Chirac) will now likely distance themselves from the current government pending an inquiry. The US may press for sanctions against Lebanon should the UN Resolution 1559 remain unfulfilled. In the near term, these factors will likely exacerbate Lebanon's financing challenge; near-term official financial support is set to be very small.
- **The risk of political instability will have negative consequences for investor confidence, at least in the short term.** The likely decline in tourist receipts, higher conversions of lira deposits into FX and other channels of capital outflows will very likely put renewed downward pressure on FX reserves. A delay in the formation of a new cabinet (particularly in case the May elections were to be disrupted) would further postpone key structural reforms, particularly in the area of fiscal policy. This would re-ignite concerns about the sustainability of Lebanon's massive public debt stock (170% of GDP). The flow of funds from Lebanese expatriates and from private Gulf investors (who have been supporting Lebanon's finances through large deposits in its banking system) may also decline sharply (and even reverse in case of prolonged instability).

Chart 1 Lebanon: 2009 Eurobond swap spread (bid)

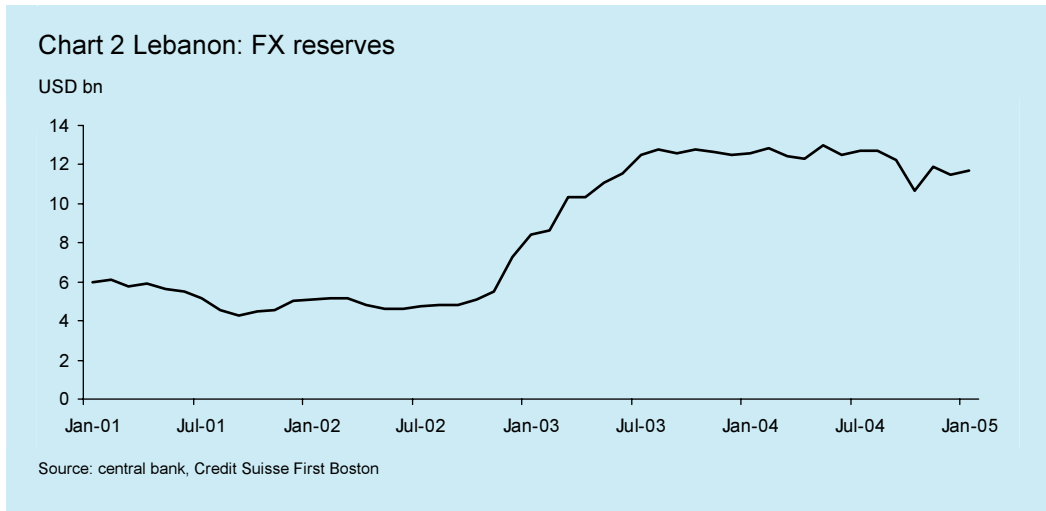
Basis points



Source: Credit Suisse First Boston

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- **The claim by a hitherto unknown Islamic militant group that it killed Hariri because of his close ties to Saudi Arabia is unlikely to be taken at face value.** It does appear much more likely to us that Hariri died because of his increasingly vigorous opposition to the presence of Syrian troops in Lebanon, and his ability to rally opposition to pro-Syrian political forces, including the current transitional government. Specifically, Hariri recently downplayed the need for Syrian military presence in the country. Syria quickly condemned the atrocity as an act of terrorism, but the blame will likely initially be pointed northwards. However, Lebanon's history of violence and the sheer complexity of the regional political landscape cannot exclude a shrewd provocation meant to implicate Syria or their allies in Lebanon (including President Lahoud). For now, exact motivation for and perpetrators of the bombing are unknown, and all kinds of conspiracy theories will doubtless be advanced.
 - **In September 2004 Syria forced Lebanon to abrogate its constitution and extend President Lahoud's term by three years.** The Syrian-orchestrated move was widely condemned internationally, including in the UN Resolution 1559, which called for the withdrawal of Syrian troops and the dismantlement of Hezbollah. An arch-rival of Lahoud, Hariri resigned as prime minister (along with many other cabinet members) in October 2004 and later joined forces with the Christian opposition and Druze leaders to challenge the pro-Syrian government. Despite having previously cooperated with the Syrians, Hariri was assuming an increasingly anti-Syrian stance. For example, he said that while he did not wish to breach the Taif Accord (which set the terms of the power-sharing deal that ended Lebanon's civil war), he did not think Syria needed a physical military presence in Lebanon in order for its interests to be safeguarded.
 - **Parliamentary elections scheduled for May now look highly uncertain, if not outright unlikely.** Hariri's assassination is a serious blow to prospects of orderly parliamentary elections this spring. Even before the killing, the Lebanese opposition had become increasingly vocal, demanding the resignation the pro-Syrian government and accusing the government of attempting to manipulate the forthcoming elections by imposing an electoral law that favored the government-backed candidates. For example, the opposition argued that the proposal to divide Beirut into three different constituencies along religious lines was designed to undermine Hariri and limit his influence in the new parliament. Hariri had told a local newspaper (*As-Safir*) yesterday that he would stand as an opposition candidate and that he would continue to fight against the government's proposed electoral law in its current form, especially the segmentation of Beirut. The Lebanese parliament was due to commence discussions on the proposed highly contentious electoral law today. We think the killing may consolidate the anti-Syrian opposition, but it will further polarize the country overall.
 - **Hariri's death makes substantive economic reform all the more unlikely.** Hariri was the key architect of the Paris-II financial rescue deal reached in November 2002 (involving Western and Arab creditors, as well as domestic banks) that pulled Lebanon back from the financial precipice. He was also a proponent of fiscal deficit reduction and privatization. The new transitional government has proven rather more reluctant on these fronts.

- **In the near term, investors should watch the FX reserves data carefully to monitor the fallout.** Gross FX reserves of the central bank amounted to \$11.6 bn at end-January, only marginally below the all-time high of \$12.4 bn in early 2004. However, the still large current account deficit (12.3% of GDP at end-2004) has been financed mainly by drawdowns on Lebanese individuals' foreign assets, and it is not clear if this portfolio adjustment will continue in light of the heightened political uncertainty.



- **Other economic variables to monitor the economic impact of the political shock are (i) domestic interest rates and (ii) budget data.** Finance Minister Saba recently discussed with President Lahoud the outline of the 2005 draft budget, which is due to be presented to the cabinet soon. Saba has also announced that the government will pay the National Security Fund \$146 mn (0.7% of GDP), which represents part of the arrears for 2003 and 2004. Saba said the payment of the remainder of arrears will be determined in the near future, though he did not reveal how large these arrears are. Payment of the arrears is good news generally, but it does reduce the resources available for debt servicing. We think that the government will post an overall fiscal deficit this year of around 10% of GDP, compared with 12% of GDP in 2004, but this is dependent on the maintenance of tight fiscal discipline and low effective interest rates, things that are quite uncertain now.
- **External debt spreads have not reacted much to the news yet, probably because there is little trading.** We think that spreads ought to widen significantly on this sad development. CSFB has had a long-standing underweight in Lebanon in our external debt model portfolio, and this political tragedy reinforces our concerns. In our most recent *Debt Trading Monthly* we had Lebanon at a 2% underweight relative to benchmark, despite the fact that the economic news has been improving recently. For the plain fact of the matter is that without political stability, Lebanon will not be able to undertake the painful economic reforms needed to claw its way out of a debt trap (public debt to GDP is 170% of GDP).

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