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When Social Contracts Fail: The Economic and Investment Implications of Social Protests

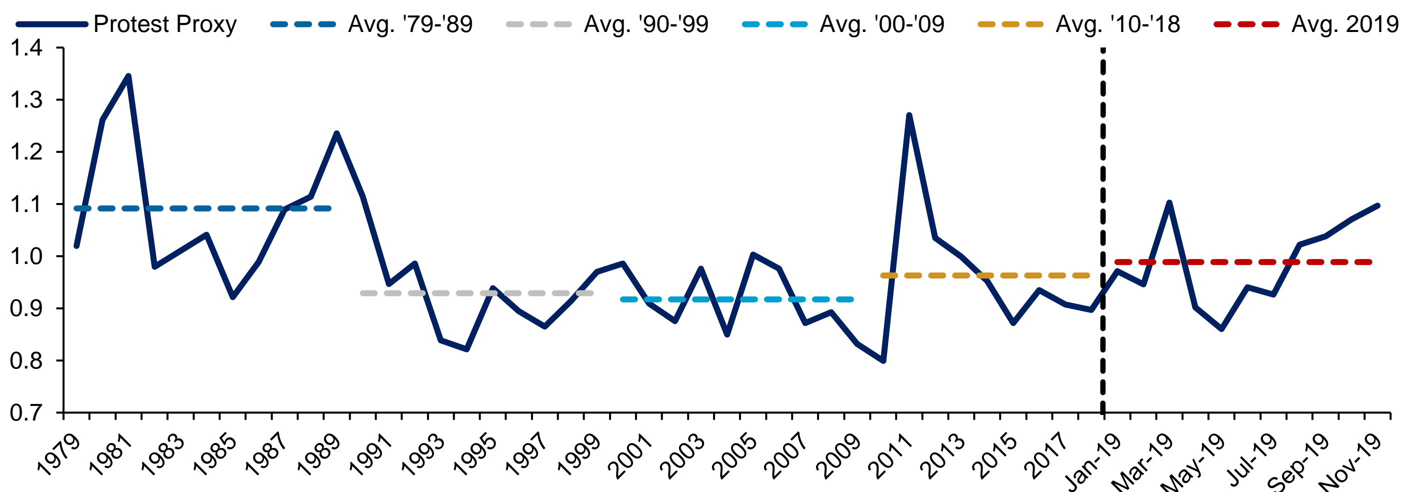
By Francisco Campos-Ortiz, PhD, Latin America Economist, Global Macroeconomic Research
Mehill Marku, Senior Investment Strategist
Giancarlo Perasso, CEEMA Economist, Global Macroeconomic Research
Cathy Hepworth, CFA, Co-Head, Emerging Markets Debt Team

Throughout various corners of the world, signs of social unrest are surging in both the streets and the ballot boxes. Even nations typically deemed institutionally sound, economically mature, and politically stable have experienced disquieting, headline-grabbing developments. This list includes protests in several countries in Latin America as well as the prominent demonstrations in Iraq, Lebanon, and Hong Kong. Yet, incidents of social protests can happen nearly anywhere (e.g. the "gilets jaunes" of Paris in 2018 and France's most recent pension-related protests), and frequent instances of innocuous triggers make them highly challenging to foresee.

From a broader perspective, 2019 has been a historically tumultuous year. While 2011's Arab Spring featured a spike in observed periods of social protests, 2019's average number of protests reported in global news outlets has been the highest since the turbulence of the 1980s (see Figure 1).

In an attempt to understand the extent to which these developments could affect the economic outlook of the countries involved and to identify fundamental changes in alpha-generating opportunities, this paper begins by establishing a few common characteristics of the protests. It follows with a brief rundown of some of the most talked-about episodes as well as a discussion on the respective macroeconomic and investment implications.

Figure 1: Protest Reports (% of Total Articles Scraped)



Note: The above graph pulls data from the Global Database of Events, Language, and Tone (GDELT). GDELT uses artificial intelligence to scrape thousands of broadcast, print, and online news sources around the world. Their event database logs this information and allows users to filter by specific criteria. We filter for "Protest," which returns entries capturing episodes of political dissent, demonstrations and rallies, obstruction to leadership decisions, and similar events. Due to GDELT's exponential growth over time, the database normalizes results against the total number of articles scraped over each event date or window; thus, the underlying series is expressed as a percent.

Sources: GDELT Event Database and PGIM Fixed Income. As of November 30, 2019.

The Common Threads

In our assessment, social disillusionment—largely fueled by lackluster economic growth, rising inequality, and inadequate governance—is a key common thread among the uprisings observed throughout different latitudes. Social contracts forged in boom years set the expectations for rising living standards. However, in several instances, these contracts have become impossible to fulfill amid the lackluster growth during the current global expansion and the resultant weakness in the prices for many commodities. Corrective policies adopted to address lower paths of potential growth and to narrow macroeconomic imbalances heightened the frustration felt by the affected societies.

While some countries managed to provide a democratic outlet for these pressures (e.g., Italy, Malaysia, and Mexico), diverse catalysts—sometimes as seemingly innocuous as a tax on a mobile application—ignited tumults in several other locations that have developed into grassroots protests.

Another feature generally shared by these movements is the lack of clear leadership and a coherent list of demands. Instead, protests have organically mobilized via social media and mass-text messaging. The protests' lack of leadership and unified demands has consequently delayed their resolution. Governments have lacked the clarity as to what measures might meet the protestors' demands or with whom they should even negotiate.

General Investment Implications

Broadly speaking, social protests pose downside risks to the outlook of the affected economies, which may dissuade some cross-over investors. But for those who understand the underlying dynamics of the respective country, the periods of social upheaval could present investment opportunities. The key is differentiating between countries with deeper challenges and more limited space to accommodate social demands and those where the shift of macroeconomic fundamentals is more likely contained, rendering disruptions more transient in nature. Importantly, countries intent on improving social conditions will likely need ongoing access to external debt markets in order to fund these improvements.

Furthermore, many of these protests underscore how governance and social issues are intractably intertwined. Recognizing which governments have the scope to improve social conditions could highlight those countries or regions that may emerge from the current unrest with demonstrably improved ESG criteria amid their growing prominence in investment considerations.

With the exception of Argentina's expected debt restructuring, most of these disruptions are unlikely to result in a credit event, though imbalances could increase. Rather, these incidents are more likely to result in a repricing or a credit rating adjustment on the external debt assets in affected countries. With this in mind, we turn to the idiosyncratic features of the specific protests. This list mostly comprises Latin American countries given the breadth of protests in the region, but Iraq, Lebanon, and Hong Kong are included as well.

Venezuela (External credit ratings: C, Selective Default, Withdrawn)[1]

Early in 2019, the potential ousting of Venezuela's authoritarian Chavista regime gained momentum. A supportive combination of domestic factors (country-wide protests led by acting president Juan Guaidó, who was appointed by the National Assembly in January) and external forces (the international community's recognition of the Guaidó government and the Trump administration's hawkish rhetoric towards the Maduro administration), appeared to exert enough pressure to prompt defections among authorities bulwarking the regime's continuity. However, the movement petered out as such defections failed to crystallize, and Venezuela slipped among the Trump administration's foreign policy priorities.

Implications: Continued social unrest and international pressure may eventually lead to regime change in Venezuela. Otherwise, the permanence of the Chavista regime—with support from Russia, China, and Cuba—is poised to preserve the dismal social, political, and economic conditions that have come to characterize the country.

In this context, any restructuring or recovery on sovereign and PDVSA debt will be delayed until a suitable government can effectively begin to rebuild the country.[2] Venezuela's debt currently trades at extremely distressed levels, reflecting the economic collapse and social crisis, as well as OFAC sanctions. A regime change would be a necessary condition for any improvement in prices.

[1] The external credit ratings in this paper refer to long-term foreign currency ratings and are based on those provided by Moody's Investors Service, Standard & Poor's, and Fitch Ratings, respectively. PGIM Fixed Income maintains proprietary credit ratings on sovereign and corporate debt, and, in some instances, these ratings may differ materially from those provided by the external rating agencies.

[2] PDVSA refers to Petróleos de Venezuela, S.A., the state-owned oil company.

Peru (External credit ratings: A3, BBB+, BBB+)

In Peru, social protests erupted during the showdown between President Martín Vizcarra—himself appointed in 2018 following the resignation of President Kuczynski over corruption allegations and the ensuing socio-political turmoil—and congress over legislative initiatives aimed at curtailing corruption and enhancing governance. The showdown has led to a constitutional crisis that is yet to be fully resolved.

Implications: The good news is that we do not anticipate material changes to the prudent stewardship of Peru's economy, thereby keeping macroeconomic imbalances contained and manageable amid a fluid political backdrop. Nonetheless, there are risks that persistent political crosscurrents keep anti-establishment sentiment simmering, thereby bolstering the electoral viability of unorthodox alternatives in the country's upcoming elections.

Peru's external debt metrics remain solid, while its sovereign debt spreads remain relatively resilient. From a relative value perspective, its sovereign and corporate bonds continue to appear rich. The local bond market has significant foreign ownership, and changes in the outlook for monetary policy as well as concerns about the financing of the current account deficit could impact local bonds and the sol.

Ecuador (External credit ratings: B3, B-, B-)

Measures undertaken as part of Ecuador's adherence to its IMF-backed adjustment and reform program, which were meant to improve its fiscal position, were subsequently reversed after disruptive social protests eroded governability and crippled economic activity. It's a situation where a more cautious political class has provided a less supportive backdrop for the adoption of structural reforms.

Implications: Ecuador's adjustment agenda will likely follow a more protracted trajectory and/or less ambitious targets given the vexing political constraints that hindered the implementation of the originally-planned IMF program. The IMF and other multilaterals are expected to maintain their support for Ecuador based on their view that the Moreno administration is genuinely committed to a more sustainable economic path, albeit over a longer time horizon. Nevertheless, lingering social malaise could raise the probability for populism's return.

Ecuador's sovereign debt has underperformed after repricing significantly since the protests intensified. The bonds may continue to retrace some of the selloff once the government passes measures to improve its growth and fiscal outlook. A near-term credit event is unlikely, but investors will be very selective over the next few years in their willingness to continue financing the country.

Chile (External credit ratings: A1, A+, A)

A moderate increase to the subway fare in Santiago opened a "Pandora's Box" of pent-up nationwide grievances regarding public services, economic inequality, retirement income, and the constitutional underpinning of this market-oriented economy. The immigration of Venezuelans and their impact on the labor market may have deepened citizens' economic frustrations.

Implications: Chile's policy framework will likely undergo meaningful changes in order to accommodate more progressive policy goals. Nevertheless, the leeway afforded by a low debt-to-GDP ratio, institutional safeguards (such as its reputable central bank and the country's sophisticated local financial market), relatively high human capital, and continued adherence to principles of private property and rule of law, will likely prevent these shifts from severely undermining Chile's creditworthiness.

Chile's external debt has widened along with quasi-sovereign and corporate bonds, but it still trades at relatively tight levels given that its credit ratings appear too high, and we expect downgrades. The currency sold off considerably in the wake of the protests and will likely remain volatile given the "dollarization" by local investment funds and the country's exposure to trade uncertainty. Central bank policy may adjust higher to support the currency, and local bonds do not appear to sufficiently reflect this risk.

Bolivia (External credit ratings: Ba3, BB-, B+)

In his pursuit of a fourth consecutive term, former President Evo Morales triggered significant social unrest amid perceptions of degraded institutional safeguards and reports of a rigged election in October (as was documented by the Organization of American States). These actions prodded the Bolivian military to withdraw its support for the regime, thereby prompting Morales to resign.

Implications: The new government in Bolivia has yet to articulate a consistent policy agenda to address the country's broad economic imbalances. There is limited external debt from Bolivia, and the bonds benefit from a technical scarcity. Therefore, they trade rich relative to fundamentals.

Argentina (External credit ratings: Caa2, CCC-, CC)

In Argentina, protests against austerity measures and the economy's stagflation may not have appeared in news headlines as glaringly as those in other Latin American countries. Yet, social malaise was unequivocally reflected in the ballot box with the defeat of incumbent President Macri and the return of Peronism.

Implications: The incoming Fernández administration has yet to articulate how its campaign rhetoric will translate into a coherent, politically-credible economic program aimed at reversing the ongoing economic recession, reining in inflation, managing a challenging debt situation, and maintaining its relationship with the IMF. Given citizen's limited appetite for continued adjustment, the Fernández administration will likely face some severe headwinds.

We await details of the new government's policy framework and its sequencing decisions on debt given the external liquidity pressures facing the country. The future role of the IMF remains crucial. Current levels on external law, external debt likely reflect a floor in recovery value, and there is likely sufficient incentive for the new government to preserve market access over the medium term.

Brazil (External credit ratings: Ba2, BB-, BB-) & Mexico (External credit ratings: A3, BBB+, BBB)

Social unrest has remained relatively contained in Brazil and Mexico, Latin America's two largest economies and issuers of external debt. Both countries are arguably in different stages of the protest cycle as they recently inaugurated populist leaders pledging to address the grievances that led to the repudiation of establishment political parties. Yet, the continued growth underperformance of both economies, the festering security and rule-of-law conditions in Mexico, or the social mobilization capability of Brazil's former President Lula (recently released from prison) vs. the reform drive of the Bolsonaro administration, could sow the seeds for potential outbursts of social discontent.

Implications: A relatively stable social backdrop has afforded the new governments in Brazil and Mexico with degrees of freedom to pursue their respective policy agendas. In Brazil, much-needed pension reform legislation is set to become law. The reform drive will likely extend into next year with additional improvements to Brazil's fiscal regime, privatization initiative, and central bank independence. In Mexico, the AMLO administration has bolstered spending on social programs and PEMEX support while preserving a sensible fiscal stance via substantial budgetary reallocations. However, lingering concerns over economic management, corporate sector policies, and rule-of-law shortcomings have dented Mexico's growth outlook.

A mix of opportunities in hard currency quasi-sovereigns and corporates exists in Mexico and Brazil given the base case of stable policy frameworks, manageable outlook for economic imbalances, and relatively diversified economies. The outlooks for the local bond markets and the currencies differ given the trajectory for monetary policy: Mexico has recently initiated policy cuts, while Brazil has approached the end of an easing cycle. In addition, in Brazil, locals are seeking higher yields outside of the country, while in Mexico, the prospects for the passage of the USMCA and the potential benefits from the U.S./China trade war support the outlook for financing its current account.

Lebanon (External credit ratings: Caa2, CCC, CCC)

Although the riots in Lebanon were triggered by the proposed introduction of a tax on the WhatsApp messaging application, popular discontent had been growing in recent years amid lack of economic growth, high unemployment, widespread corruption, and rising inequality. The government's policy to rely on remittances, Eurobond issuance, and transfers from friendly regional governments to finance large fiscal deficits has become increasingly difficult to sustain, hence the proposed tax. Authorities responded to the protests by presenting a new budget that abolished the WhatsApp tax and included higher taxes on bank profits as well as a voluntary default on some government bonds held by the central bank. This failed to appease protesters and the resignation of prime minister Hariri soon followed. At present, there is still no prime minister in Lebanon, and a political solution to the crisis remains distant.

Implications: Lebanon's outlook is highly challenging as protests have become more violent. In recent years, Lebanon has been ruled by a coalition with the most important positions allocated by sectarian guidelines: the PM is a Sunni (who is supported by Saudi Arabia and the UAE), the president is a Christian, and the leader of parliament is a Shia (backed by Iran). Until recently, this arrangement guaranteed peace, but also stifled political competition, resulting in rent-seeking and corruption practices that led to economic stagnation/decline and rising inequality. While the current coalition agreement should be revised, geopolitical interests are strong and foreign interference will continue dictating Lebanese politics.

Any successful new government will need to impose reforms that affect entrenched, vested interests and reduce the political incentive amongst the country's ruling elite to pursue these policies. The base case is a continued, muddle-through scenario, but one which appears increasingly unlikely. Lebanon has a debt-to-GDP ratio of 150%, and large redemptions are due in 2020. "Creative financial engineering" by the central bank can only create some breathing room before it runs out of options. New elections cannot be ruled out, but the outcome is difficult to predict because the protesters do not (yet) appear to be organized as a political force. Given political uncertainty, the outlook

for Lebanon's sovereign debt is unclear, and bond prices are trading around $45. The timing, scope, and severity of any debt re-profiling or restructuring remain uncertain, thus warranting cautious positioning.

Iraq (External credit ratings: Caa1, B-, B-)

In Iraq, security forces triggered the protests with their harsh suppression of a rally led by a group of graduates that were demanding jobs. Two days later, the government transferred Lieutenant General Abdel-Wahab El-Saedi from the counter-terrorist forces to the ministry of defense—a move that the citizenry and El-Saedi himself considered a demotion and sparked widespread protests against the Iranian influence in Iraq. In the following weeks, protests evolved in more general, less-sectarian terms considering that Iraq faces problems that are similar to those in Lebanon, but in an even more challenging economic and political situation. Although the war is officially over, unemployment has remained high, private sector growth has developed slowly, and corruption has been rampant. Furthermore, delivery of basic services has not improved as the domestic security situation deteriorates. The repression of protests has been severe, leading to more than 300 deaths in the last two months. Recently, prime minister Abdul-Madi resigned under the pressure from the protests and the religious hierarchy. Anti-Iranian sentiment has also grown and become more violent in recent weeks.

Implications: The protests have not affected Iraq's oil production but, contrary to protests in previous years, demonstrations are taking place in the oil producing region, blocking roads that could affect port operations. On November 19th, protesters blocked activity at Khor al-Zubair port, the country's second largest. Prior to that, access to Umm Qasr Port was also cut off. Should oil exports be significantly affected, an unlikely occurrence in our view, the economic outlook would deteriorate and further protests along with escalating violence could not be ruled out.

While Iraq clearly has the buffers to weather declining oil prices and temporary disruptions to oil production, it is a country with considerable political risks as it balances Iranian and U.S. interests by way of a fragile coalition government. Additionally, internal sectarian strife has been less of a concern recently, but could pose risks in the future. Despite a strong balance sheet and low debt levels, these risks and institutional weaknesses underscore Iraq's weak credit ratings. That said, external bonds appear attractive given their spread levels and shorter durations. This can provide better downside protection and clarity as well as less risk of fundamental weakness if the balance sheet were to deteriorate over them medium term.

Hong Kong (External credit ratings: Aa2, AA+, AA)

The initial trigger for the protests was a proposed law by the territory's Chief Executive that would have allowed Hong Kong residents suspected of criminal activity to be extradited to mainland China. As the governments in Hong Kong and China initially refused to formally abandon the bill, the popular movement intensified, violence increased, and protesters' demands evolved into a clear political platform. It centers on calls for a free and democratic election of the territory's representatives, including its Chief Executive, as well as demands for investigations into incidents of police violence against protesters. Considering that such demands challenge China's sovereignty over Hong Kong, Beijing has continued to request that Hong Kong's government address the protests. This dynamic has set off an escalatory cycle of violence, the most recent episode being the clashes inside and around the Polytechnic University where use of tear-gas, rubber bullets, and fire bombs created the image of a city at war.

At the core of the Hong Kong protests is a belief among the protestors that eventual direct rule by China could compromise their freedom, end the region's judicial independence, and subjugate Hong Kong's unique identity, which is increasingly important to its citizens. For its part, Beijing believes that Hong Kong should be an integral part of mainland China, that the "one country, two systems" was not intended to allow Hong Kong to develop into a separate sovereign entity, and that China retains the sovereign right to establish direct rule over the territory. Given the conflict between these visions and goals, the crisis in Hong Kong appears highly intractable over the near term.

Implications: The resolution to the crisis will have serious economic and political implications for China, Hong Kong, and much of Asia. China's utmost hope may be that the protests recede over time. Cracking down on the protests using Chinese police and/or military units would likely inspire a mini-insurgency in Hong Kong with serious economic consequences for the territory as a financial center for China, while also minimizing any realistic prospect of a peaceful re-unification with Taiwan where anti-Chinese sentiment has been on the rise amid the Hong Kong protests. Such actions could damage China's reputation, especially in Asia, and undermine its global efforts to develop a soft-power image. A military crackdown would most likely trigger international sanctions, including from the U.S. administration. However, we do not expect the U.S. to use the so-called "nuclear option" by revoking Hong Kong's preferred status, despite the recent passage of the Hong Kong Human Rights Democracy Act.

Most corporate bonds in Hong Kong trade rich, and it remains to be seen if the market reprices these assets going forward.

Conclusion

The episodes of social protest documented in this paper stem from accumulating grievances and disappointment with current and expected economic conditions among large swathes of the respective populations (Argentina, Chile, Ecuador, Iraq, Lebanon and Venezuela) and/or fundamental governance deficiencies (Bolivia, Hong Kong, Iraq, Lebanon, Peru, and Venezuela).

These movements pose a main, short-term risk of disrupting economic activity. Over a longer-term horizon, their effect is chiefly a function of how much capacity these economies have to accommodate social demands of additional public spending (or at least more gradual adjustments) and their ability to raise potential growth while more effectively spreading the benefits of economic expansions. Addressing governance-driven social turmoil could set the stage for meaningful improvements among ESG criteria that have gained prominence in investment deliberations. Except for Hong Kong, the economic and political ramifications of protests are mostly limited to the countries in question. This backdrop provides the opportunity for differentiation as investors update their investment theses. The more global scope of the Hong Kong case, on the other hand, requires a broader framework of analysis with geopolitical and global trade considerations complementing the movement's distinctive features.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of December 2019

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