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Saudi Arabia bets the house (or Kingdom)

Saudi Arabia's Crown Prince Mohammed bin Salman is taking on the following monumental tasks all at once:

- Aggressively consolidating his power via mass arrests before taking over from his father King Salman
- Transitioning away from an oil-based economy
- Curtailing the power of the religious establishment
- Waging an intensified proxy war against Iran across the Middle East

Tackling just one of these challenges would be daunting enough. Accomplishing all four at the same time will require an even much higher level of skill and no small measure of luck.

The ruthless consolidation of Prince Mohammed Bin Salman's power

The Crown Prince recently had more than 200 people arrested for corruption, including many princes and government ministers. His aim was to make a statement regarding who is in charge and to send a warning that no one is untouchable. The most prominent arrests included his most powerful rival, Prince Miteb bin Abdullah, head of the National Guard and son of the late King Abdullah, and Alwaleed bin Talal, the Kingdom's richest man (net worth of $17 billion).

Under the kingdom's traditional governing system, control over certain sectors was divided among several branches of the royal family. Power has now been concentrated in the hands of King Salman, Crown Prince Mohammed bin Salman and his branch of the family. This notably includes control over all three Saudi security services: the military, internal security services and the National Guard.

The Crown Prince has also curtailed the power of the religious establishment. He has, among things, severely limited their power to arrest, detained dozens of hardline clerics and expanded the space for women in public life, including allowing them to drive motor vehicles.

The Crown Prince feels that having absolute power is necessary in order to successfully modernize the economy, take on Iran, and curtail the power of the religious establishment, whose rigid control over society is viewed as an impediment to the social flexibility required for a successful modern economy.

Arresting elites is very popular, regardless of circumstances

Despite the fact allies of the Crown Prince were untouched, the mass arrests received strong public backing, especially among young Saudis, who widely feel that the elite class is corrupt (70% of the population is under the age of 30). **The Crown Prince has made the calculation it would be much easier to successfully implement reforms and austerity measures if the public felt that certain members of the elite were taking a major hit as well.**

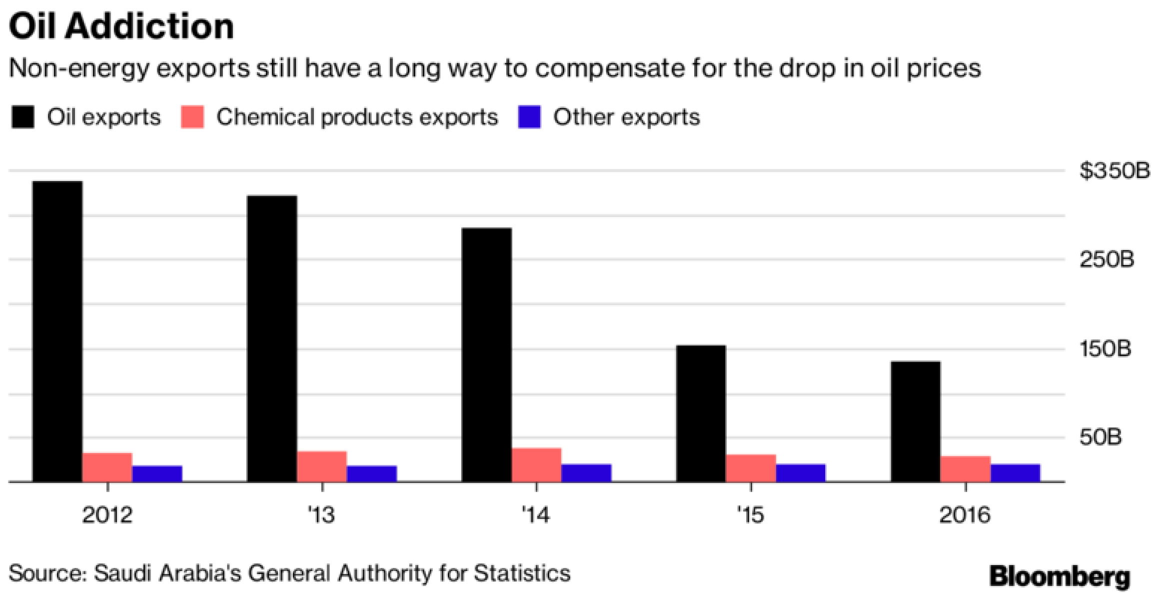
This strategy has been successfully used in the past in other countries. Russia's President Vladimir Putin cemented his authority when he first came to power by jailing or driving into exile many oligarchs, particularly those with political ambitions. China's leader Xi Jinping has also arrested many prominent individuals to both deal with corruption and eliminate political rivals. These arrests were widely supported by the Russian and Chinese people.

Finally, U.S. President Donald Trump recently tweeted his support of the Saudi crackdown: "Some of those they are harshly treating have been 'milking' their country for years!" The Trump administration feels that it has finally found a leader that wants to truly reform the economy and crack down on radical clerics.

Ambitious plans to reform the economy

These mass arrests coincide with efforts to diversify the economy away from oil via a campaign called Vision 2030. The plan includes the ambitious target of increasing non-oil revenues from just over $40 billion in 2015 to $160 billion by 2020 and $260 billion by 2030.[1] The plan also entails deep cuts to government spending and subsidies.

Stating that the Saudi government has its work cut out for it is a major understatement. About 90% of the country's revenues derive from oil and 70% of working Saudis are employed by the state (versus an OECD average of just over 20%).



Source: "Saudi Arabia's Great Makeover Can't Afford to Fail This Time," Bloomberg, October 15, 2017

Cutting spending has proven to be exceedingly difficult. A sharp backlash recently forced the government to reverse cuts made to public-sector pay/benefits in September 2016. An increase in water prices was also quickly reversed after similar complaints.

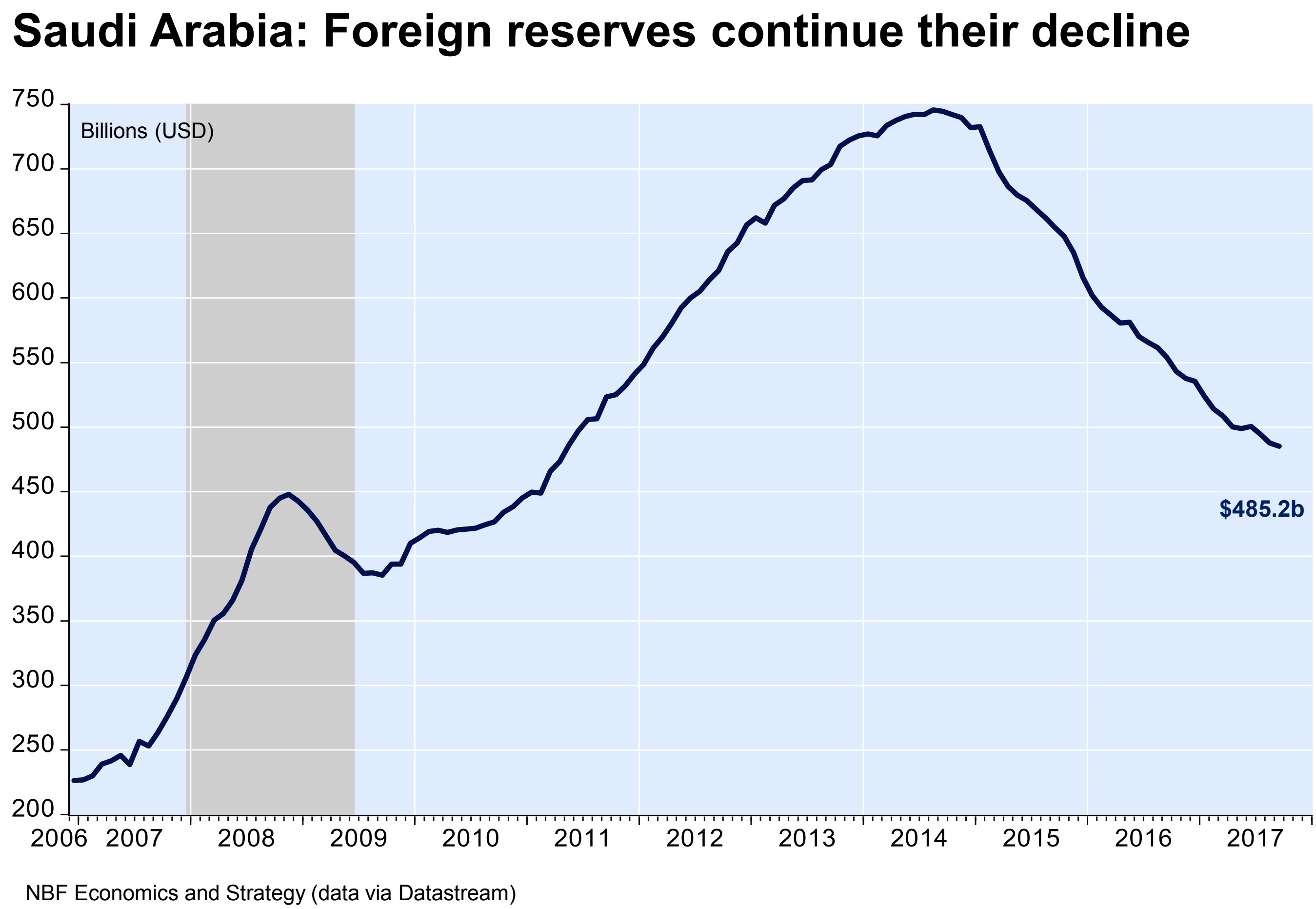
It is important to note, also, that this is not the first time Saudi Arabia has attempted to implement major economic reforms. About 15 years ago, the government unveiled a program titled "The Future Vision for the Saudi Economy: 2020". It is widely viewed to have been a failure.

Saudi's Arabia increasingly precarious finances

Historically, Saudi Arabia has responded to periods of political unrest by buying peace. The most recent example being its decision to spend an additional $130 billion on social benefits in 2011 to avoid the risk of the unrest from the Arab Spring spreading to the kingdom. **This strategy is no longer an option because the country's finances are increasingly being squeezed by the drop in oil prices on the one hand, and by massive government expenditures on the other.**

Since the end of the era of oil at $100 a barrel ended in 2014, the country's reserves have plunged from a high of $730 billion in August 2014 to $485 billion today.

[1] "Saudi prince unveils sweeping plans to end 'addiction' to oil," Reuters, April 25, 2016



While having $485 billion in foreign currency reserves is still by all accounts very impressive, they must be placed in the context of Saudi Arabia's massive financial commitments. These include extremely generous social programs, subsidized energy, highly paid government jobs and significant financial support for allied countries throughout the Middle East, not to mention direct military involvement in Yemen (more on this later).

Despite a recent price increase, gasoline in Saudi Arabia is still dirt cheap. A litre of 91 octane gasoline costs only 0.75 riyals (20 cents).[2] Such low prices encourage demand, which means a whopping one-third of oil production is earmarked for the domestic market.

Saudi Arabia also has one of the world's largest military budgets as a percentage of GDP: 10% (or $64 billion annually). This in stark contrast to the 3.3% of GDP that the United States spends on defence.[3]

All of this means that Saudi Arabia needs oil prices to be at $73-$77 per barrel in order to be able to balance its budget. The current WTI price is trading in the $55-$57 range.

Not surprisingly, the country went from running a budget surplus of 12% of GDP in 2012 to posting a deficit of 17% of GDP ($79 billion) for 2016. Public debt as a percentage of GDP went from less than 2% in 2014 to 13% in 2016. **While this debt level is still very low, it is important to note that the country's borrowing power is predicated on its reserves not falling to dangerously low levels.**

Replenishing reserves via asset confiscation

The Crown Prince hopes that the recent arrest of many members of the Saudi elite will not only allow him to consolidate power but also to partially replenish the country's foreign reserves. The government is targeting assets worth at least $100 billion that

[2] Saudi Arabia Delays Energy-Subsidy Cuts," Bloomberg, July 6, 2017
[3] "TRENDS IN WORLD MILITARY EXPENDITURE, 2016," Stockholm International Peace Research Institute, April 2017

it claims were accumulated illegally. Over the longer term, it hopes to reclaim as much as $300 billion. The risk is that the mass confiscation of assets will prompt more people to attempt transferring funds out of the country.

Saudi Arabia's proxy war with Iran

The imminent defeat of ISIS is setting the stage for increased tensions between Iran and Saudi Arabia, the self-proclaimed leaders of the Shia and Sunnis. This is reinforced by the fact that the Saudis are increasingly wary of Iran's growing influence in Iraq, Syria, Yemen and Lebanon.

In Yemen, Saudi Arabia's war against Iranian-backed Houthi rebels who ousted the Yemeni government in 2015 is mired in a costly stalemate. Saudi Arabia recently accused Iran of committing an act of war by providing the missile Yemeni rebels used to fire at the Saudi capital—an accusation Iran has denied.

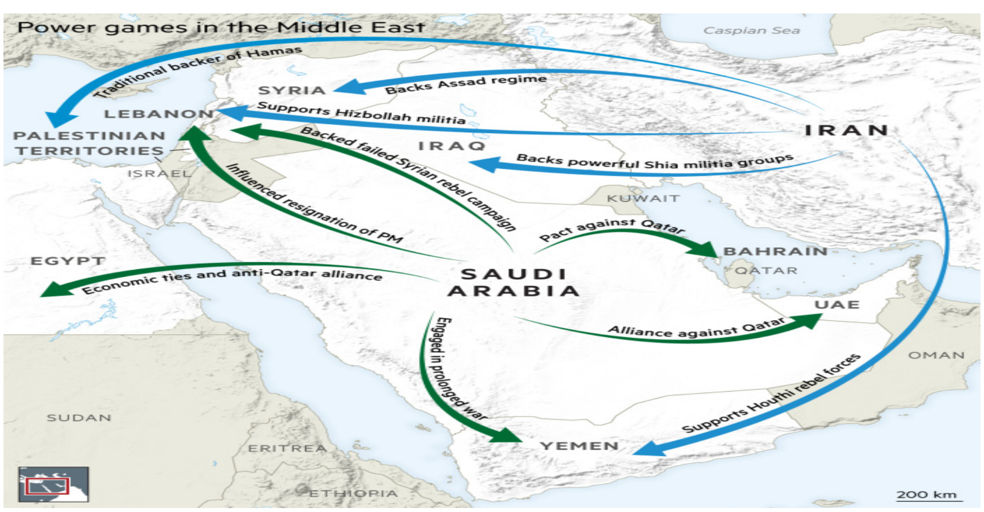
The latest tension point is Lebanon. Saudi Arabia reportedly pressured Lebanese Prime Minister Saad Hariri to step down over his refusal to take a more hard-line stance against Hezbollah, which both Saudi Arabia and the United States consider a terrorist organization. His potential resignation has several potential negative consequences for Lebanon:

- It threatens the fragile coalition government made up of Sunnis, Shias and Christians and could exacerbate ethnic tensions. Unfortunately, Lebanon is no stranger to turmoil. It endured a civil war from 1975 until 1990 and a brief but deadly conflict between Hezbollah and Israel in 2006. Lebanon is also struggling with the task of hosting 1.5 million refugees from the Syrian War, which represent 30% of its population. This is the world's highest per capita concentration of refugees.
- Lebanon's debt-to-GDP ratio is among the highest in the world (150%). It relies heavily on tourism and remittances from its diaspora to finance this debt and maintain its currency peg to the U.S. dollar. There is a real risk that Saudi Arabia and other Gulf nations will be tempted to expel Lebanese nationals. About 220,000 work in Saudi Arabia alone and send back close to $2 billion in remittances annually.[4] **Many influential Saudis feel there is no point in maintaining close economic ties with a country that is increasingly slipping under the sway of Iran/Hezbollah.** Foreign currency reserves (including gold) in the amount of $54 billion afford Lebanon a cushion to better withstand economic distress over the short to medium term.

Despite increased tensions, a direct war between Iran and Saudi Arabia remains unlikely in the near term. Saudi Arabia's military is currently bogged down in Yemen and is nowhere near ready for another war. What's more, it would likely not be able to win a conflict against Iran's battle-hardened army without immediate assistance from a war-weary United States. Finally, such a war would throw a massive wrench into Saudi Arabia's highly ambitious plans to reform its economy.

As for Iran, its proxy Hezbollah is still fighting in Syria and dealing with the financial burden of paying medical costs and benefits to the wounded and to the families of those killed. Iran has also just emerged from a long period of sanctions and is in no position to bear the financial burden of a direct conflict with Saudi Arabia potentially backed the U.S.

The proxy war between Iran and Saudi Arabia



Source: "Middle East tensions rise as Iran and Saudi Arabia jostle for power," Financial Times, November 9, 2017

[4] "A political shock throws Lebanon's economy back into crisis," AP, November 11, 2017

However, growing tensions have raised the risk of a military conflict in the region. One of the greatest risks is an outbreak hostilities between Israel and Hezbollah/Iran. **Israel has already warned it will not tolerate a long-term Hezbollah and Iranian presence in Syria, particularly along its border. The potential unravelling of the nuclear agreement between Iran and the United States only adds to these tensions.**

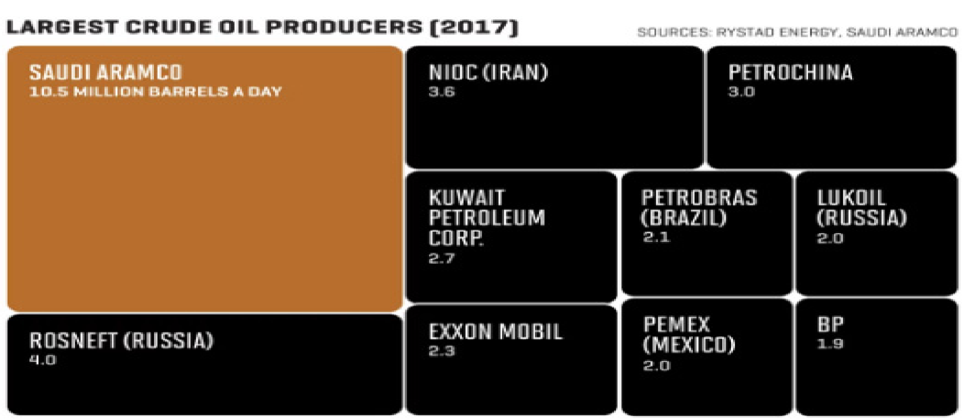
Israel, Saudi Arabia and other Gulf nations are also worried that Iran's growing influence in Syria has brought it closer to its goal of building a highway running from Iran through Iraq to Syria. Such a route would make it much easier for Iran to supply Hezbollah with arms/fighters and generally expand its geopolitical influence. **All of this lends credence to reports that Israel and Saudi Arabia have entered into a once unthinkable informal alliance to contain Iran/Hezbollah.**

Iran's potential land route to the Mediterranean

Source: "The growing power of Iran and Hizbullah worries Israel," The Economist, September 12, 2017

The planned *Aramco* IPO runs into major hurdles

In early 2017, Saudi Arabia announced a future initial public offering of 5% of Aramco, its state-owned oil company. The company produces more than 10 million barrels a day and claims to have reserves of 260.8 billion barrels.[5] The government asserts the value of Aramco to be \$2 trillion, which means that 5% amounts to \$100 billion. The proceeds of the IPO would finance the modernization of Saudi Arabia's economy.



Source: "Inside Saudi Aramco's Kingdom of Oil," Fortune, October 24, 2017

[5] "Inside Saudi Aramco's Kingdom of Oil," Fortune, October 24, 2017

However, it did not take long for this proposed IPO to run into several hurdles.

- Reports have surfaced that Aramco's market value could be much lower. Estimates range from $1.5 trillion to as low as $400 billion. The secrecy surrounding its reserves (never publicly audited) and the political risks of state ownership were cited as reasons for the lower valuation.
- Should Aramco be listed on the NYSE, it could be vulnerable to legislation passed by the U.S. government in 2016 allowing Americans to sue Saudi Arabia for the alleged role of certain Saudi nationals in the 9/11 attacks.
- Saudi Arabia's efforts to control oil production and pricing via OPEC could be seen as illegal (i.e., price fixing) by regulatory authorities in New York or London.

All of these potential hurdles have set in motion a plan B: Forgo an international IPO in favour of a private sale to Chinese investors. PetroChina and Sinopec have reportedly offered to buy 5% of Aramco directly. Going this route has several advantages:

- If the sale price is disappointingly low the figure could remain secret.
- Aramco would not have to publish legally audited estimates of its oil reserves or reveal the extent to which it is entangled with the government.
- A private placement to Chinese investors would further cement ties between the world's biggest producer and the world's largest consumer of oil.

However, it is highly unlikely that a private placement would value the company anywhere close to the $2 trillion claimed by Saudi Arabia unless large supplies of cheap oil were included in the deal.

Conclusion

Prince Mohammed bin Salman is literally betting the house he can successfully consolidate power, reform the economy, rein in the religious establishment and contain Iran—all at the same time. He is also hoping public approval of the arrest of many elite figures for corruption will make average Saudis more willing to endure economic reforms and austerity measures.

In the short term, we do not see substantial threat to the Crown Prince's power. The reasons for this are twofold: 1) He has spent the past year meticulously planning his rise to power; and 2) The vast majority of the elite will very likely fall in line to avoid imprisonment and preserve their privileges. This includes buying their freedom via cash payments.

Over the longer term, however, the Crown Prince is in a race against the clock to implement reforms and grow the economy before reserves sink to dangerously low levels and/or the public begins to turn against his austerity measures. Unemployment is at 12.8% overall and youth unemployment is at 30%. To avoid a public backlash, the government needs to create millions of jobs for its younger generation. Indeed, its large youth population means the country's labour force could nearly double in size by 2030. **The Crown Prince's consolidation of power means Saudis will know who to blame if things do not work out.**

Key factors to watch

- Will capital reserves continue to decline at the same rapid pace as in the past few years due to low oil prices, capital flight and continued sub-par economic growth? An increase in the price of oil and/or the successful seizure of significant amounts of capital from the elite under arrest could slow the pace of decline of reserves and grant the kingdom more time to enact its reforms.
- Will the Crown Prince be able to consolidate his power without scaring off the foreign and domestic capital needed to fund his ambitious reforms? Further mass arrests could be perceived as an indication the Crown Prince has not fully consolidated his power and this could drive away investors.

A failure by Prince Mohammed bin Salman to attain his ambitious goals would not only risk destabilizing Saudi Arabia, but the wider Middle East as well.

Oil prices

As for the impact on oil prices, despite increased tensions, OPEC and certain non-OPEC producers will probably still agree to extend supply cuts (1.8 million bpd) that are due to expire in March 2018. However, the higher prices will also increase the temptation for certain countries struggling with deficits to cheat on their quotas.

From a geopolitical risk perspective, while we do not foresee a direct Iran-Saudi conflict, the tensions surrounding these two countries only adds to the geopolitical uncertainties roiling oil markets. These include a looming debt default in Venezuela, a territorial dispute between the Iraqi government and Kurds and perennial instability in Libya and Nigeria that could flare up at any moment. NBF Strategy and Economics foresees the WTI price of oil staying within the $55 to $60 range for the coming year.

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