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Saudis on a Sword Edge - A special Oxford Analytica Conference Call

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The past few days have seen the detentions of some of Saudi Arabia's most senior political and business leaders in the name of an anti-corruption drive. Saudis have been left shocked, and some -- although not necessarily younger Saudis -- aghast. International investors are unnerved.

What to make of Crown Prince Mohammed bin Salman's palace purge? Is it the impetuous action of a young but unseasoned prince, impatient to clear any opposition to his ambitious blueprint for modernising the oil-dependent economy over which he will soon rule? Or is it a naked, clumsy grab for power that will inevitably prompt a counter-attack by the kingdom's ancien regime, particularly its religious and royal conservatives?

The adventure in Yemen, the provocation of a political crisis in Lebanon, and the surprisingly intractable dispute with Qatar all exacerbate the feud with Iran and could lead to greater regional destabilisation. These are treacherous waters for foreign businesses and investors, the groups that the crown prince will need to rely on if he is to realise his ambition of diversifying Saudi Arabia's economy.

Domestic politics

There is uncertainty whether recent events in Saudi Arabia constitute genuine anti-corruption efforts or merely a political purge. Indeed, elements of both are present. Moreover, they can be considered a populist move, with the goal of strengthening Mohammed bin Salman with the youth support base he is trying to appeal to, while deterring others from organising against him. They are part of a strategy of establishing a more populist and authoritarian type of regime and transitioning away from the traditional dynastic monarchical system.

The arrests are a continuation of a long-term project of consolidating power in the hands of Mohammed bin Salman, marking a shift from the power-sharing among senior members of the Al Saud, sons of the kingdom's founder, to a new style of governing. As power has begun to pass to the new generation, there has been increasing centralisation since 2015, first with the appointment of Mohammed bin Salman as defence minister and first deputy prime minister, then with the removal of the former crown prince, Mohammed bin Nayef. Various sons of former kings and crown princes have also been ousted from key posts. This trend has continued with the recent arrests, particularly with the removal of Prince Mit'ab bin Abdullah as head of the National Guard. The National Guard, composed of mainly tribal fighting forces, had been run by Mit'ab's father King Abdullah for decades.

The appointment of a new head of the National Guard also continues a second trend that can be observed in Mohammed bin Salman's consolidation of power, namely the assumption of control of the security services. After the removal of Mohammed bin Nayef, King Salman appointed a much less well-known member of that branch of the family to run the interior ministry (a longstanding Nayef fief) and began to siphon off various functions from the interior ministry to the royal court. Naval commander Admiral Abdullah bin Sultan has also been removed.

Some of those arrested have been reputed to be corrupt for a long time. Many in Saudi Arabia therefore welcome this move. In a system where ordinary young people have few job prospects, corruption is ripe, nepotism is an intrinsic part of the system and equality of opportunity is a pipe-dream, Mohammed bin Salman's moves could nurture the hope of a brighter future. The crown prince's actions can be interpreted as a message to young Saudis that things are going to be different; that there are reasons to strive and work in the private sector. He is trying to

demonstrate a break with the past. Corruption will likely be reduced as a result of the recent actions, which communicate that the old ways of doing business will no longer be tolerated.

Nevertheless, in countries where institutions are weak and not independent of politics, anti-corruption purges are often politically selective, as in this case. Before Mohammed bin Salman was appointed to head the newly-established anti-corruption committee, Saudi Arabia already had an anti-corruption commission, although it lacked powers of prosecution. Now, with the committee headed by the top political figure in the country, this has changed. Investors who would like to see a Saudi Arabia where there is less corruption, less reputational risk and a stronger rule of law can see some potential, but they are also concerned about the political entanglements and wondering whether the choice of targets will be reliably systematic or arbitrary.

Economic and wider regional perspective

Shortly before the arrests were announced, Lebanese Prime Minister Saad al-Hariri resigned from his office. He blamed Iran's regional interference, but was seemingly prompted by Riyadh. This was symbolic of Saudi efforts to impose their will in Lebanon and the wider Middle East, pushing back against Iran, which has a much more effective track. On the same day, Yemeni Huthi fighters launched a ballistic missile at Riyadh: Saudi officials declared this an act of war by Iran and Lebanese Hezbollah.

Mohammed bin Salman's efforts to project himself as a new and powerful leader with ambitions to enact radical changes will inevitably affect the regional rivalry with Iran. However, it seems unlikely that the internal purge will change the terms of the Iran-Saudi relationship.

Egyptian President Abdel Fattah el-Sisi has meanwhile issued statements supportive of Mohammed bin Salman, but has also called for a measured response vis-à-vis the situation in Lebanon, counselling against an escalation towards war on Hezbollah or Iran.

The other salient feature of regional politics in recent months has been the Qatar situation and the very close ties between Mohammed bin Salman and Mohammed bin Zayed in the United Arab Emirates (UAE). It was announced today that the UAE central bank would cooperate with the freezing of accounts and attempts to track down the assets of Saudis under investigation.

Investment and business implications

The key pillars of Mohammed bin Salman's flagship economic plan, 'Vision 2030', include large-scale urban development, financial-sector reform and privatisations, notably of state oil firm Saudi Aramco. The entire Saudi economy essentially depends on the government's distribution of oil income. Even the 'non-oil' economy is heavily reliant on government contracts. Most Saudis are not employed in the private economy, which is instead dominated by foreigners whose remittances are a large outflow on the current account. The oil price is now below the budget 'break-even' price, causing a substantial budget deficit and falling foreign-exchange reserves. It is estimated that government funds will likely last between three and four years before foreign-exchange reserves run out.

Mohammed bin Salman inherited this situation; he did not cause it. In recent months he has, however, become frustrated. The Saudi Aramco initial public offering (IPO), his signature policy, is stalled because of legal problems with the Justice Against Sponsors of Terrorism Act (JASTA) in the United States, which means that any IPO will likely be bedevilled by a suit from victims of the 9/11 attacks. There are also questions over whether the company is truly worth two trillion dollars (the crown prince's claim), as well as concerns within Aramco itself and the wider government about whether selling part of the future stream of oil income is a good idea.

Meanwhile, the actual liquid foreign-currency resources that Mohammed bin Salman commands in the so-called sovereign wealth fund, the PIF (Public Investment Fund), which journalists report at 230 billion dollars, are in fact likely below 50 billion dollars, much of which is already committed to the SoftBank venture. In that light, his

promise a few weeks ago to kickstart a project called NEOM, a 500-billion-dollar megacity in the desert, looks optimistic.

The one institution that has been untouched in the recent crackdown is the Saudi Arabian Monetary Agency (SAMA, the central bank). Meanwhile, pressure within the government to devalue the riyal has substantially diminished. Mohammed bin Salman, backed by the IMF, had been opposed to devaluing the riyal all along. Saudi Arabia depends on imports, and a devaluation would result in domestic inflation.

For the latest crackdown, the attorney general has announced the suspension of more than 1,700 accounts. SAMA Governor Ahmed Abdulkarim Alkholifey has sought to reassure banks and corporations by emphasising that only personal bank accounts were being suspended and that corporate interests would remain unaffected. Proceeding more widely against the targeted individuals will prove difficult, as the money they are suspected of having acquired is largely held outside not only Saudi Arabia but even the wider Gulf Cooperation Council (GCC). The UAE has distributed lists to its banks of accounts that might be frozen, but this is in line with a GCC cooperation agreement. It is highly unlikely that Swiss, US or British authorities would freeze bank accounts on the request of the Saudi government. There has been talk of efforts to take back misappropriated funds worth 800 billion dollars; in reality, the assets in question are likely to be closer to 100 billion dollars.

Market reactions have been fairly muted so far. Dollar bond spreads show risk has increased, but they are still not at anything like crisis levels.

Nevertheless, it is likely that recent events will discourage investment in the country. The individuals currently under arrest will presumably leave the country as soon as they are released and will not deploy further funds in Saudi Arabia, although they might sign agreements with the PIF and act upon them. While the detention of members of the royal family might be understandable in terms of power positioning, the detention of individuals in the private sector is baffling, as these are presumably the entrepreneurs and foreign investors on whom Mohammed bin Salman relies to push through his Vision 2030. Furthermore, since the private sector is strongly intertwined with the government sector, it is likely that foreign investors will be more cautious as a result of the recent actions. While the moves might bring cash benefits in the short run, they are likely to damage the economy in the longer term.

Q & A session

Prospects of future missile attacks on Riyadh

Saudi Arabia has so far successfully shot down missile launches from Yemen; this is likely to continue. The government has issued a clear statement blaming Iran for firing the missiles and retaliated by tightening the blockade on Yemeni ports. There seems to be a calculation across the region that there is a red line that neither the Saudis nor the Iranians want to cross, as both parties are seeking to avoid a direct military confrontation.

Likelihood of a conservative backlash

Mohammed bin Salman is creating a variety of enemies by pushing through quite radical change on all fronts: domestically, religiously, in the realm of foreign policy and with regard to the ruling family. However, he is also making it clear that it is extremely risky to organise against him. This might become particularly difficult as he is further tightening the existing restrictions on freedom of speech. It is difficult to see where a counter-mobilisation within the royal family would come from. It would be risky for any prince to mobilise against Mohammed bin Salman -- not least because so many individuals could potentially be vulnerable to similar corruption accusations.

In September, Mohammed bin Salman arrested several prominent clerics, among them Sheikh Salman al-Ouda, who had in the past given voice to opposition sentiment. Independent-minded clerics have consequently been

relatively quiet, despite Mohammed bin Salman carrying out a range of social changes that are not in line with their views.

The main challenges are likely to surface a few years down the line. While now it is difficult to judge the success of Mohammed bin Salman's various economic projects, if he cannot gain the investment that is needed to create jobs and unemployment rises, this will create fertile ground for unrest and disturbances, which could potentially be harnessed by his enemies in the royal family, among clerics or even externally. Attracting foreign investment is therefore key for the crown prince, but also partially beyond his control. Mohammed bin Salman will try to convince the international business community that the anti-corruption move was sincere. A lot of companies will nevertheless be put off, as they identify new political risks that are difficult to navigate.

Youth support and street protests

Street protests are relatively unlikely to occur in Saudi Arabia. They are illegal and have in the past been largely confined to the Shia-majority areas in Eastern Province. That is one of the reasons why it is not clear how opposition to Mohammed bin Salman would manifest itself. A 2011-style 'Arab uprising' is difficult to imagine in Saudi Arabia.

There are questions over the solidity of youth support for the crown prince. Certainly, some young people welcome the fact that the prince is focusing on the economy and introducing new forms of entertainment. Ultimately, the crucial issue is employment. If unemployment rises, domestically-educated Saudis, who are likely to be particularly hard-hit and may harbour anti-Western sentiments, could feel that Mohammed bin Salman is trying to push the country too far towards globalisation and economic neo-liberalism. Young people are a heterogeneous population segment in Saudi Arabia, and if some of them feel that they are not being included in this move towards a new kind of economy, they could oppose it.

Comparisons with the anti-corruption campaign in China

The Saudi situation is best considered on its own merit: the economic structure is very different from in most other non-Gulf comparators, including China.

One of the critical elements if Saudi Arabia is to progress from oil-dependence to a more balanced economy is the need to raise more taxes from Saudi citizens. This is starting to happen in a small way, with VAT being introduced next year. There have already been some taxes on fizzy drinks, but much more is needed. The newly-transparent budgetary accounts show how little taxation the Saudi state derives from anything other than Saudi Aramco activities. This is not sustainable in the medium term. There seems to be a three to four-year window for the accounts to be turned around, so significant changes could be coming. The aftermath of a corruption drive could legitimise more taxes. This also has important regional implications because most other Gulf states will have to consider similar constraints. The currency peg might also merit a fresh look over the next couple of years.

It is also worth noting that the number of Saudis in the workforce is higher at present than it was six or seven years ago, with an increasing number now employed in the private sector (1.8 million, compared with 1.2 million in the public sector).

Beginning of a revolution?

Arguably, events like this usually occur in the early stages of revolutions. This does not mean that the present case is a revolution, only that similar events have led to revolutions in the past. Particularly in urban areas, the boundaries of acceptable behaviour have been pushed wide open after 40 years of constraint. The entertainment commission set up by Mohammed bin Salman last week organised a big biker festival in the capital, Riyadh; this would have been unthinkable only two or three years ago.

Mohammed bin Salman is in many ways clearing out the 'ancien regime': the question of what will succeed it remains open.

Many leading media figures have been detained in this crackdown, which might be interpreted as a deliberate attempt to control and censor the media. Mohammed bin Salman has dealt cleverly with the international media and has commissioned considerable research into social media sentiment among youths. However, there are serious red lines for online debate: criticisms of the king and his son are illegal under anti-terrorism legislation, carrying a prison sentence. There has been a further clampdown on freedom of speech since King Salman came to power.

Gulf regional impacts

The magnitude of what is happening in Saudi Arabia has put the conflict in Qatar in the shade for the time being. The Qatar standoff has reached an equilibrium for now: Qatar goes about its business, and the blockading states show no interest in making any concessions. The message going out on both sides is that the status quo can be sustained for a considerable amount of time.

In the short term, a little fillip for oil prices is not going to cause harm. It is too early to judge the wider impact of this move against a big part of the Saudi business sector on business activity in the region. It could depress business in Saudi Arabia for some time, with knock-on effects for the UAE and elsewhere.

Next move from Tehran?

Iran will be looking at the whole situation very closely. Iranian authorities moved quickly against one of the more hardline newspapers to tone down some of its references to the missile launch from Yemen. Iran is unlikely to see any benefit from escalating its conflict with Saudi Arabia, confident it has the upper hand in most areas. Nevertheless, Tehran will be watching every Mohammed bin Salman with a certain amount of trepidation, given his lack of predictability.

Future of foreign workers in Saudi Arabia

There has already been a large outflow of migrant workers in recent years, as the country has cracked down on irregular immigration and sought to push its Saudi-isation drive. That trend will probably continue, as one of Mohammed bin Salman's chief political priorities is to make sure that there are more job opportunities for Saudis. Women driving will also have a significant impact, both because more women will work and because they will employ fewer drivers. If tensions increase, Saudi Arabia could also potentially expel Lebanese nationals. So far there have been no signs of this happening, but it is an option, and Gulf countries have in the past used expatriate workers as a political instrument against their home governments.

Prioritisation of projects

State-sponsored development will be the focus. The private businessmen who are under arrest at the moment may be pressed to agree to support public projects sponsored by Mohammed bin Salman. This would be in tension with the original plan of Vision 2030 to shrink the state sector and release the spirit of the entrepreneur, boosting the local stock market. Now that he is firmly in control, it may be less likely that Mohammed bin Salman would relinquish power in the state sector and hand it over to the uncertainty of privatisation.

Aramco sale

Mohammed bin Salman has claimed Saudi Aramco is worth around 2 trillion dollars. This is unlikely. The Economist and Financial Times assessed it at 1 trillion dollars; it might, in reality, be slightly below. There are risks for the Saudi state in selling off a stake. If Aramco sale proceeds are re-invested, money could potentially be lost on that transaction. Oil exports, on the other hand, are a relatively stable and secure source of income.

A deal over JASTA would be an important precondition for Aramco shares to be listed in New York. One alternative being suggested is private placement to China; traditionally, this would be cheaper than a public valuation. In return for a large up-front payment, China may seek guaranteed long-term oil deliveries below the market price - not a good deal for Aramco.

Prospects for urbanisation

There might be some movement on urban redevelopment as a result of the latest arrests. Royal family members control a lot of Saudi land, holding on to it or selling to developers at high prices. This means that ordinary Saudis find it difficult to afford urban properties. If the crackdown on royal corruption reduces the price of land, that will accelerate urbanisation.

New international adventurism

It is difficult to predict the next direction for Mohammed bin Salman's international adventurism. One of the lessons of the Yemen war has been the limited effectiveness of the Saudi military machine. By contrast, adversary Iran is more experienced and much better at power projection.

Additional questions

Regional implications for Lebanon, Yemen and Iran

A Saudi military offensive against Lebanon is unlikely, given the existing entanglement in Yemen, the huge costs of which are not accurately reflected in the fiscal data. However, the country could become an arena for renewed proxy confrontation with Iran, with Gulf states using economic pressure effectively. If Hezbollah is pushed into mobilisation, this could draw a reaction from Israel.

Local and tribal constituencies

Mohammed bin Salman has now established more direct control over all the security services, including the tribally-dominated National Guard (now headed by Prince Khalid, a former undersecretary at the ministry). While he is emulating his grandfather in seeking control of all levers of power, he does not necessarily have the same connections into the rural and tribal segments of society. Such tribal and family connections extend into the business sector and cross GCC borders. This could constitute a long-term weakness for the crown prince. Shia communities in Eastern Province are also largely excluded from his calculations, but these are relatively weak.

Religious establishment

The clerical establishment has been significantly weakened in recent years, even before Mohammed bin Salman came to power. They may oppose his policies, but will do so extremely discreetly. Mohammed bin Salman is completely rewriting the agreement between the Al Saud and the Wahhabis. For a long time, over the latter controlled social life, justice and education. King Abdullah already began to dilute their influence over justice and education. The crown prince is now seeking to privatise much of the education system, aiming for 25% of Saudis to be privately educated -- outside the control of the religious establishment. His social changes -- allowing public entertainment and above all women driving -- show that he is making decisions in areas that were formerly their responsibility.

Practical economic implications: transparency, investment, diversification

Although centralisation of power is one goal, it is also clear that stopping blatant corruption is a major aim of Mohammed bin Salman's new campaign. However, there is a danger that the politicisation and lack of predictability of the initiative will fatally undermine efforts to create a more transparent, accountable market economy? All of the crown prince's economic plans for diversification and investment -- which are key priorities - - depend critically on private investment. Riyadh is cutting public spending on projects because of budget pressures. This means that investor sentiment is key -- and recent moves are likely to make both the local and international private sector very cautious.

Regime stability

Whether or not the latest moves increase regime stability depends on how cleverly Mohammed bin Salman gathers new bases of support. He has eliminated potential adversaries and gained popularity within an important youth constituency but also damaged mechanisms for securing support from wider religious, tribal and business elites. The key test is whether he will rebuild them in a new form.

Mohammed bin Salman has no designated heir -- perhaps because the title of deputy crown prince was introduced under King Abdullah largely because previous crown princes were so old, and to send a signal about the transition to the younger generation. Given Mohammed bin Salman's youth and family controversies, the position may remain vacant.