
The Saudi Gamble

Mushtaq Khan¹, November 16, 2017

The stunning actions taken by the Saudi government on November 4th, are just the first step. Apparently unprovoked, they nevertheless show a great deal of planning. The arrest of 11 princes, 4 sitting ministers and several dozen former ministers – not to mention the helicopter crash that killed Prince Mansour bin Muqrin, and 8 other officials – has shaken the Saud family to its core.

When King Salman ascended to the throne in 2015, Crown Prince Muqrin bin Abdulaziz was the consensus choice, but opted out of succession four months later, to open up the way for the next generation. King Salman's nephew (Muhammad bin Nayef), who was the designated deputy crown prince, was automatically elevated.

The succession was suddenly changed in June 2017, when King Salman replaced Crown Prince Muhammed bin Nayef with his favorite son – Muhammed bin Salman (MbS). An op-ed in the New York Times on November 9th, correctly states that this implies that Saudi Arabia may now be called Salman Arabia, as King Salman has effectively cut out his nephews from the royal lineage. There is also the mysterious gun-battle that allegedly killed a prominent Prince, which *had* made the news, but has since fallen off the radar.

On the same day as the purge, the Lebanese Prime Minister announced, while on a private trip to Riyadh, his resignation on Saudi state television. PM Hariri read out a statement criticizing Hezbollah (and Iran) and expressed fears of being assassinated. The series of events (Hariri's arrival in Riyadh, the formation of a special anti-corruption taskforce, the announcement of PM Hariri's resignation, and the arrest and incarceration of prominent Saudis) all happened within 24 hours.

By any standard, these events are dramatic enough to be compared to the iconic final scene of the classic film – The Godfather [1972]. Many have simply called it an old-fashioned power grab.

Complications multiply

On November 5th, a ballistic missile launched from Yemen was intercepted on the outskirts of Riyadh. On November 6th, Prince Mansour bin Muqrin (the son of the ex-crown prince) was killed in a helicopter crash on the Saudi-Yemen border. In response to the missile attack, the Saudi government issued stern warnings to both Lebanon and Iran, claiming that this was tantamount to an act of war against the Kingdom. Later on November 6th, President Trump weighed in by Tweeting his confidence in King Salman and MbS, stating that those who had been arrested had been “milking” the country.

For a country like Saudi Arabia, this kind of upheaval is very uncharacteristic. Saudi has always been managed by a very conservative, deliberate, consensus-driven family – what has happened, is like a respected elder statesmen who shuns social media, suddenly Tweets his mental breakdown to the entire world. Obviously, people will worry if the gentleman will ever be the same again. The real question is: what triggered the outburst, and why now?

In my view, the “corruption” purge, the threat to Hezbollah and Iran, and the confused status of the Lebanese PM, have already pushed the Kingdom to the point of no return. In particular, the Saudi

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government's commitment to prosecute the corruption trials publically, is a legal minefield: if corruption is defined as dipping into sovereign wealth for private gain, then all Saudi royals are corrupt.² The legal infrastructure in Saudi Arabia is defined by royal decree, which means the ruling King creates the legal due process. This is clearly problematic.

Public sentiments

As expected, global media has not been able to gauge Saudi sentiments to this series of events. However, some steps taken by MbS in the recent past, have been well received:

- Vision 2030 is touted as the blue-print for a new Saudi economy, which seeks to wean the Kingdom off oil revenues and generate "suitable" jobs for young Saudis;
- A royal decree has defanged the feared *virtue police*. Disallowing this organization from arresting people, is a significant step, as it neutralizes the state's power to enforce strict behavioral norms on citizens and expats living in the Kingdom;
- The decision to allow women to drive in mid-2018, is equally significant, as it reverses a social more that many tribal Saudis feel strongly about;
- There are plans to allow public cinemas to operate for the first time in the country's history; &
- The corruption purge will appeal to the average Saudi. Austerity imposed on Saudis after oil prices collapsed in mid-2014, did not impact the huge Saud family, which is known for its lavish lifestyle. Hence, exposing their alleged corruption will find a sympathetic audience.

By most standards, these are welcome changes. The significance for Saudi Arabia is particularly acute – around 70% of the population is below the age of 30, tech savvy and either unemployed or working in dead-end government jobs. Against a smaller number of elders who are deeply conservative, these changes are likely to be welcomed by young Saudis. In terms of numbers, these changes would garner an easy majority; however, Saudi is a hierarchical society where age bestows authority and power. So even if a clear majority prefers these changes, the views of the elders will dominate – unless the entire social order is overturned.

What has not been analyzed, is how these changes will sit with the bureaucratic clergy; the Wahhabis; the disenfranchised royals; businessmen who are not aligned with MbS; and the majority of royals who are against the Aramco IPO. Furthermore, with the exception of the royal family of Abu Dhabi, it is highly unlikely that other members of the GCC were forewarned about the November 4th actions.

The arrest of Prince Mutaib bin Abdullah for corruption (who was heading the National Guard³), has effectively consolidated all military power in Saudi Arabia under the command of the crown prince. In the past, the three armed groups were kept within different royal families to create a balance of power.⁴ Now, one family (King Salman's) can arrest and incarcerate any other member of the royal family. This concentration of power, is unprecedented.

² Technically speaking, the oil & gas fields in the Kingdom are the private assets of the Saudi King. Petrodollar inflows are either invested abroad, or are used domestically. The avenues for extracting money are diverse: generous monthly stipends to royal family members; construction projects with inflated costs; exclusive licensing agreements with foreign suppliers; having tracts of land endowed to specific people who then sell these to private investors; etc. The point is, royal family members have access to hydrocarbon revenues in various forms. What is categorized as corruption, is subjective.

³ In addition to the Saudi military, there is the National Guard and the Interior Ministry. The National Guard is specifically tasked with the security of royal family members, and is reportedly as powerful as the Saudi military.

⁴ The National Guard has been under the control of King Abdullah's family since it was created in 1962. The issue is whether members of the National Guard retain a degree of tribal loyalty to Abdullah's family, and are unhappy with the removal of Prince Mutaib. Tribal politics is the fabric of Saudi society.

With such powerful people sidelined, and possibly facing public trials to prove their corruption, a strong incentive to band together against MbS and his father has been created. This returns us to the following question: why take this step when the downside risks are quite significant, while proponents (young and moderate Saudis, and global opinion) have little say in what has happened? In my view, two issues are important to understand why the Saudi government acted: one, regional dynamics; and two, MbS's own track record since ascending to power.

Regional dynamics

The Middle East is in turmoil. The Saudi campaign against Yemen may not have much airtime in mainstream media (e.g. CNN or BBC), but the starvation and suffering of Yemeni civilians has created a humanitarian crisis that the UN says is the worst in "many decades". For the most part, global opinion has turned against the Saudi government, especially after the Kingdom retaliated to the November 5th missile attack by imposing a total blockade of Yemen.

Iran's growing regional influence is also hard to ignore. With the lifting of sanctions (as part of the Iran nuclear deal), Iran has attracted significant investment from Europe, in addition to Chinese and Russian companies that have been operating in the country for some time. Since the election of Donald Trump, Russia and China have become more assertive in their warming relationship with Iran. Israel, on the other hand, has had a right-wing government for over eight years, which is vehemently anti-Iran and unapologetically pro-Trump. This means the battle lines in the Middle East are clearly drawn, and tensions are rising.

Finally, we have the fallout of the failed 2003 US invasion of Iraq, which has created: (1) a power vacuum in Iraq, which has allowed Iran to gain leverage; (2) a Kurdish independence movement in northern Iraq, which has united Iran, Iraq and Turkey, on common ground to keep Kurdish aspirations at bay; and (3) skepticism of US foreign policy in the region (dating back to George W. Bush), with a sense that US actions are more about *shock and awe*, and less about a coherent strategy that helps its own interests.⁵ The lesson for the region, is that boots on the ground (and grit) are more effective than aerial bombardment and smart bombs.

With regional developments not playing out as expected, perhaps MbS felt that Saudi Arabia had to become more proactive and muscular. Perhaps the thinking is that sufficient positives for the US and Israel, would secure US support for Saudi, ex-post.⁶ It's simple enough: take a hard stance against Iran to neutralize its regional influence; lead other monarchies into a closer alliance with the US (and Israel); and use the newfound common interest between GCC leaders and Israel, to forge a lasting solution for the Palestinian problem, and to confront Iran. All three suit President Trump, who is likely to showcase his Palestinian solution as the *deal of the century*.

MbS's track record

While many support MbS's reforms to create a moderate Saudi Arabia, his track record so far has been checkered. Despite being unable to build a credible coalition, MbS pursued an aggressive campaign in Yemen; this campaign has stalled, and now he owns the disruptive changes implemented in the Kingdom. With a more pliable US foreign policy, and growing domestic discontent (especially after MbS was made crown prince), perhaps the Saudi escalation is meant to up the ante, and play for a much larger prize – a

⁵ Hezbollah and Russia's involvement in the civil war in Syria, appears to have settled the conflict in favor of Bashar Al Assad, which implies US failure to topple Assad – Hezbollah and Russia, have also evicted ISIS, a common goal for the US and Iran.

⁶ This means the steps taken on November 4th, and perhaps the stance against Qatar, along with Saudi threats to Lebanon, have been formulated domestically and executed without the prior approval of the US.

totally different Middle East that sustains itself more on geo-political importance, and less because of its significant oil reserves.

This is not easy, as it hinges not just on halting Iran's growing regional influence, but pushing back.⁷ In my view, it is this existential threat to the Gulf monarchies that may have triggered the sudden action by the Saudi crown prince. As oil loses its luster, US military support for the GCC becomes more uncertain; furthermore, petrodollars surpluses have been depleted and are unlikely to ever build again, and GCC countries have failed to carve out a sustainable model that creates jobs for locals. Hence, the GCC monarchies may have realized they can no longer wait and hope for the best; if they do, they could lose control of their countries.

The Kingdom is key

Reshaping the Middle East requires Saudi leadership. There is perhaps the realization that only Saudi Arabia will be able to unite the other monarchies into collective action. Perhaps the Qatar blockade was a baptism by fire, where it became clear that Oman and Kuwait were not willing to go as far as the UAE and Saudi Arabia. Furthermore, since Saudi is the least well off (in per capita terms) and also not popular with foreign investors, Vision 2030 is not just a marketing exercise, but a real effort to attract foreign money and expertise into the country.⁸ The crown prince may have realized that Wahhabism may have been the political glue that legitimized the Saud dynasty since the 18th century, but the challenges in the 21st century require dismantling this regressive ideology.

What to expect

1. Developments in Lebanon:

The circumstances surrounding PM Hariri's resignation on November 4th, continue to fuel speculation. It is now expected that Saad Hariri will return to Lebanon, but it is not clear whether he will step down. There are stories that Hariri's wife and children will not be allowed to accompany the PM, which will reinforce the view that PM Hariri (and his family) is being held hostage by the Saudi authorities. Then there is the story that Hariri's Saudi business (Saudi Oger) is bankrupt and being sued by unpaid employees, because the Saudi government owes Saudi Oger about US\$ 9 billion. This puts legal and financial pressure on Hariri to toe the Saudi line.

However, the unexpected and unified show of public support for their embattled PM, creates a very awkward situation for Saad Hariri. Since his resignation has largely been seen as orchestrated by the Saudi government, the loss of face (shame) to Lebanon's sovereignty, has unified a politically fragmented country. In my view, Hariri will be received at Beirut airport as a national hero, but with the expectation that he will not step down as PM, and stand firm against Saudi wishes. In my view, Hariri may be willing to sacrifice his Saudi business interest, while it seems highly unlikely the Kingdom will continue to detain Hariri's family against outraged world opinion.

Shifting gears, the Saudi threat to Lebanon was directed at Hezbollah. Some have argued that the warning was designed to push the Lebanese parliament to shun Hezbollah, and perhaps provoke a proxy war between Saudi Arabia and Iran, where Israel and Hezbollah clash in southern Lebanon. Saudi thinking is that when Hezbollah is overwhelmed by the Israeli army, this will weaken its role in Lebanese

⁷ The fear is not that Iran will invade GCC countries, but that Iran could encourage local populations to demand greater political and economic rights, which could result in the overthrow of the monarchies.

⁸ This explains the motivation for the sudden shift towards moderate Islam, women's rights, and challenging the Wahhabi mindset.

politics, which will allow Saudi Arabia to reclaim Lebanon (from the Shia crescent) and play the same role that Hafiz al-Asaad, once played. This outcome depends on two factors: one, Israel's appetite for an armed conflict with Hezbollah; and two, whether the battle-hardened Hezbollah militia could match and defeat the Israeli army. The latter would surely trigger a political crisis in Israel, and end the political career of Benjamin Netanyahu.

In my view, there is no appetite for civil war in Lebanon, from any side. This means Saad Hariri will side with Lebanese public opinion and remain PM, distancing himself from the Saudis. This would be viewed as a victory for Hezbollah, which would tilt the balance of power in Iran's favor; it would also be seen as a failed Saudi gamble.

2. The Saudi corruption purge:

Public opinion in the Kingdom would sour if the anti-corruption drive falls below the radar. Furthermore, the incarcerated royals would feel more empowered, which could move the Kingdom towards domestic strife. Having said this, proceeding with the corruption trials has its own challenges: who is specifically targeted, and what are the specific charges that are leveled.⁹ These developments will influence investor confidence, which is critical if Vision 2030 is to have any chance of succeeding.

The Saudi purge also has repercussions beyond Saudi Arabia. Investigation of Saudi bank accounts in the UAE – specifically Dubai – will jeopardize the model that made Dubai the destination of choice for foreigners. On the back of similar investigations of Yemeni and Qatari assets, and the possibility the Lebanese could be next, this creates uncertainty that could undermine the stability of Dubai's banking system (and the city's real estate market). In effect, the free flow of capital within the GCC, and the attraction of Dubai, makes the latter as vulnerable to Saudi actions as the Kingdom itself. Since the world tends to look at the GCC through the prism of Dubai, further financial dislocation in Dubai will undermine how the Saudi purge is perceived by the rest of the world.

3. The Aramco IPO:

Many would argue that the Aramco IPO is the centerpiece of MbS's Vision 2030. What many will not be aware of, is that Aramco is Saudi Arabia's cash-cow, and its perceived market valuation is falling with time. This is driven by the collapse in oil prices in mid-2014, and how prices have remained range-bound despite massive shocks that would otherwise have pushed oil prices to record highs (e.g. the Qatar blockade; the events of November 4th; and the growing escalation of Saudi anger at Lebanon). US shale is playing the role of capping oil prices, while there is no lower-bound. Pollution in India and China's main cities; a shift towards renewable energy; and the popularity of electric vehicles, implies that Aramco's market value will continue to fall.

In my view, Aramco could also be a factor behind the urgency (and manner) in which the Saudi purge has been implemented. The Saudi government needs to capitalize on current valuation, and also to bring in much needed money to implement Vision 2030. Jared Kushner's private trip to meet MbS in Riyadh on October 27th (which resulted in a Trump Tweet on November 4th urging Saudi Arabia to consider doing the IPO in the New York Stock Exchange), shows how Aramco figures prominently in the outlook for both MbS and President Trump.

Since MbS is committed to the IPO, he understands that moving it forward will significantly change the way the Saudi royal family operates. Potential investors will demand detailed information about how

⁹ Given global attention, these trials cannot be conducted behind closed doors, as this would only create more uncertainty about what is happening.

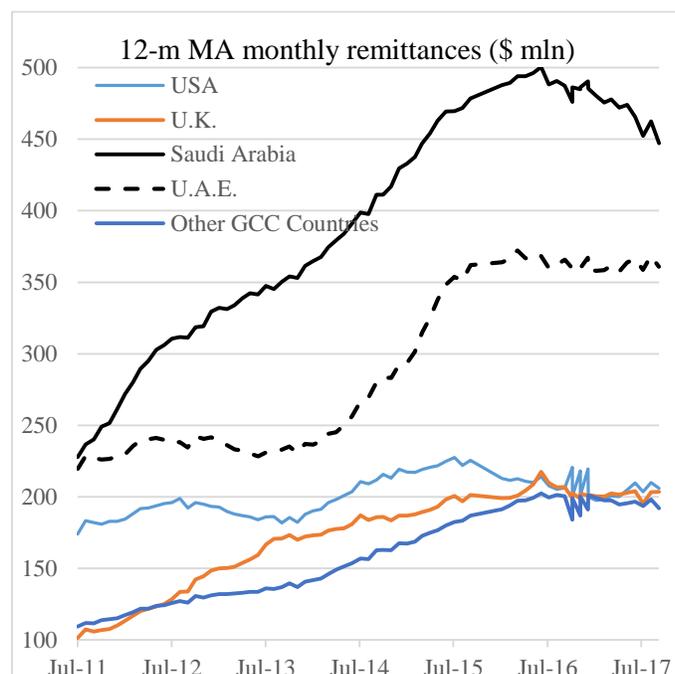
Aramco has functioned and what the outlook is. This means all future spending on the royals would be scrutinized and debated. This level of public scrutiny implies that the Saudi royal family cannot operate as it has, which dovetails with (and supports) MbS's vision that a major overhaul of the royal family (and supporting institutions) is required.

The other alternative, is that Aramco is not off-loaded via an IPO, but as a private placement. This brings in the money (albeit less than an IPO), but allows Aramco to continue to shield the Saudi royal family. In my view, MbS prefers the IPO route as it creates a check on his extended family, and gives him executive power to control the purse strings, which he needs to keep his extended family loyal to his leadership.¹⁰ Perhaps the events of November 4th, are a necessary first step in the very difficult process of selling Aramco.

4. Changing geopolitical landscape:

The Saudi crown prince and his advisers, have realized that the global order is changing, and that they need to adapt to survive. In an earlier paper, we discussed the creation of a bi-polar world, where the two camps are led by the US and China, respectively.¹¹ Saudi's role is to neutralize the growing regional influence of Iran, with overt US support. It suits the US and Israel to contain Iran, while it is in Iran's interest to weaken Saudi Arabia by pushing the Kingdom towards democracy. This would also be strongly resisted by the other monarchies, which explains why the GCC (which has always preferred the status quo) would be willing to risk getting involved in a proxy war between two superpowers.

Pakistan



Pakistan is not politically impacted by what is happening in the Gulf, as it is firmly in the Chinese camp; it also has its own challenges with domestic issues. However, as events play out in the Middle East, Pakistan is exposed to punitive actions by Saudi Arabia and the UAE. Although Pakistan has maintained very close ties with both countries, the changing geopolitical landscape, suggests that India may be a more suitable partner to the GCC monarchies, compared to Pakistan.

For Pakistan, the most immediate threat is a fall in remittances from Saudi Arabia and the UAE – the two largest sources. **Figure 1** shows the monthly inflow from the five largest sources of inward remittances. We do not expect an outright ban on fresh Pakistani labor entering these countries, but a gradual replacement of Pakistani labor in favor of Indians. Remittances from these two countries are almost \$ 10 billion per annum, which means the impact could be in the range of \$ 2-3 billion in the first year, which is

¹⁰ The King of Saudi Arabia is the sole owner of Aramco, as he is the sole owner of all Saudi oil and gas fields.

¹¹ The two camps are remarkably balanced in terms of population and the number of nuclear weapons they currently hold. In terms of GDP, the US coalition dominates, but will lose the edge in 10-15 years. The groups are: the US; India; Saudi Arabia; Israel and the UK; the other coalition is: China; Russia; Iran; Turkey and Pakistan. *The Changing Global Order*, May 2017, Mushtaq Khan, Bank Alfalah Ltd..

significant. The only upshot, is that since Pakistan is already facing a BoP crisis and needs CPEC to boost its exports¹², the magnitude of the adjustment in the external sector will have to account for this potential fall in remittances.

On a positive note, a problem in the GCC will increase the return of professional Pakistanis. As discussed earlier, the recent events in the region are likely to further damage Dubai's economic prospects, which were already reeling after the slump in oil prices. This means an inflow of experienced professionals into the country, and the repatriation of their wealth back to Pakistan. Furthermore, a medium-to-long term benefit for Pakistan, is the end of Saudi funding for religious schools and organizations in Pakistan. This would hopefully reverse a trend that started in 1980, which has changed the social and political landscape of the country. We are optimistic that the severing of financial inflows from Saudi Arabia, will bode well for Pakistan's future.

Summary

Since there are many moving parts in this analysis, a summary would be helpful. Mohammed bin Salman wants to create a prosperous Saudi Arabia, and seeks to do so via social and economic reforms, and by repositioning the Kingdom to be more forceful in the region. The social-economic reforms entail a moderate face of Islam; women's rights; a purge against corruption; and moving towards the sale of Aramco. In terms of its geopolitical positioning, MbS seeks to be more determined in his Yemen campaign; more muscular with Hezbollah in Lebanon; deepen the Kingdom's relationship with the US; and embrace Israel (as a partner) to find a permanent solution to the Palestinian problem.

Despite good intentions, the manner in which MbS has pushed through his changes, does not bode well for him. More specifically:

- A make-over for Saudi Islam is much needed, but resistance from conservatives; the clergy and Wahhabi ideologues, cannot be underestimated;
- The exposure from the corruption purge (names; companies; amounts), will not just destabilize the Saudi economy, but also regional hubs like Dubai. This will sour investor sentiments, especially since one of the charms of the GCC was the lack of documentation, as these countries have no direct taxes. Since royals are specifically targeted for corruption, expect very strong pushback;
- Opening Aramco's book is like opening up a Pandora's Box. What will come out will not spare any member of the Saud family, and could question the very legitimacy of the Kingdom;
- The aerial bombing campaign in Yemen, is a flawed strategy. Without boots on the ground, the campaign has become a stalemate, with Yemeni civilians paying a very heavy price. The Saudi coalition is unable (unwilling) to launch a ground campaign, which means the stalemate will persist. Global sympathy is not with the Saudis;
- The heavy handed treatment of the Lebanese PM has already backfired. The Lebanese people appear united in favor of Saad Hariri, and global opinion has turned against the Saudis. While Saudi Arabia can still hurt Lebanon's economy (via Lebanese expats working in the Kingdom), Qatar has hinted that it could step in to compensate. By overplaying his hand, MbS now finds himself on the wrong side of history; and
- Finally we have President Trump. Many would argue that MbS could not have launched such an ambitious plan if the US had a more measured and mature president. Trump's almost irrational animosity towards Iran, could seriously undermine US foreign policy in the Middle East. This may not be a high priority for President Trump, which could explain why Israel has been so circumspect about what is happening in the GCC.

¹² Pakistan's BOP: The Calm before the Storm, May 2017, Mushtaq Khan and Danish Hyder.

Conclusion

In a geopolitical context, Crown Prince Muhammed bin Salman's gamble can be justified. It may appear heavy-handed, but given regional dynamics at play (and the stakes involved), this level of disruption is understandable. While it is not clear whether MbS's gamble will pay off, regional players appear to have taken sides. In my view, the fallout so far suggests that the Saudi gamble is likely to fail.

It is very difficult to predict what will happen in the Kingdom if the Saudi monarchy loses its legitimacy – satellite monarchies are equally vulnerable. However, with size, dynamism and a parliamentary system working in favor of countries like Bahrain, Oman, Kuwait and the UAE¹³, they may carve out a customized existence, with or without traditional power structures. In the case of Saudi Arabia, on the other hand, one would imagine a tribal, religious government that prefers to remain introverted. This should help defuse the tension between Sunnis and Shias in the region.

With Iran ascending, Israel will have to contend with a regional power. More broadly, global dynamics suggests that China is likely to prevail as a counterweight to the US. In my view, the populist agenda that gave Trump the presidency, should not be confused with his incompetent handling of his presidency. There is real appetite for introverted, nationalist policies in the United States. This means the US may pull back its global presence, and pave the way for a more stable bi-polar world.

¹³ The UAE could possibly fragment into self-contained city-states.