Saudi Arabia: short-term resilience to political transition and plunge in oil prices, but critical challenges remain

Very large available foreign reserves and assets, an insignificant public debt, a strong banking sector and the lowest marginal production cost for oil give Saudi Arabia undisputable resilience in the context of much lower oil prices and political transition to new King Salman. However, the unfavorable external environment will expose further the fragile link between redistribution policies and political legitimacy, at home and in regional terms. The medium-term political uncertainty remains the largest component of aggregate risk for the country.

The death of late King Abdullah and his succession by his last brother King Salman on January 23, 2015, occurred at a time of seismic changes affecting the whole Middle East region; the aftermath of the Arab Spring, tensions with Iran, violent fighting at or near its borders in the north (Iraq) as well as in the south (Yemen) have indeed converged with the massive decline in oil prices since September 2014 and the structural transformation of the world energy market. There should be no doubt that such changes are substantially affecting Saudi Arabia and require a deft strategy and response from policy makers.

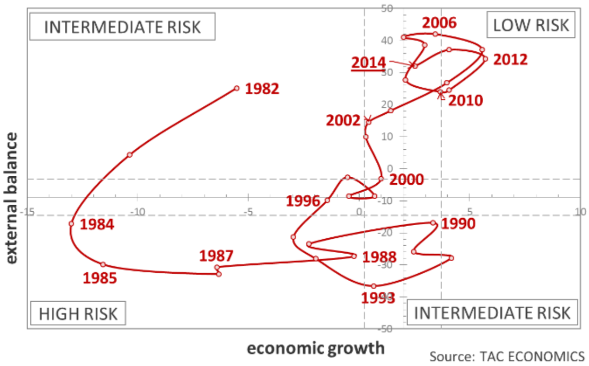
King Salman and Saudi authorities will have to overcome three challenges over the short- to medium-term: a development, a cyclical and a political challenge, each of them acute enough to be able to trigger major disruptions in the Kingdom, and with many overlaps and self-reinforcing mechanisms in-between them.

A rentier state with rapid demographics: the *development* challenge

Oil is the linchpin of Saudi Arabia's economy: oil-related activities account directly for 35% of GDP, oil exports are still more than 80% of total exports, and oil income contributes to 90% of the total fiscal intake; this means that oil revenues generate almost directly above 70% of total GDP. In parallel, Saudi Arabia remains among the top three largest producers in the world (11.8 mn bl/day in 2013, i.e. 13% of world production) and by far the largest exporter, having therefore a considerable influence on the market.

Over the long run however, such abundance of oil has not been enough to propel economic growth and development levels to desired levels. Not only Saudi Arabia exhibits today a GDP per capita substantially lower than its oil-rich neighbors (24,953 in 2013, compared with 44,552 in the UAE or 45,189 in Kuwait), but GDP growth has not been so impressive. When looking at Saudi Arabia's long-term path on our structural Growth Balance, we note that the high-growth period from mid-2000s to now is a clear exception in a long-term trajectory characterized by insufficient *economic growth*.

Growth Balance
3-year moving average



Source: TAC ECONOMICS

Though the period of increasing / high oil prices in-between 2003 and 2013 enabled an average GDP growth of 6.5%, the long-term average since 1980 is a much more disappointing 3.0%, especially when confronted to the population growth (3.4% per year, on average, since 1980). Today's bottom line is that the Kingdom still struggles to create enough jobs for the young Saudi entering the work force, while still relying on a substantial number of migrant workers.

Despite its past efforts, the country's economic diversification and job creation ability are still subdued. The dependence on the rent income remains acute, and such income will decline even tough unemployment remains an issue. The development challenge will therefore not be solved in any short-term horizon, especially when GDP growth will slow markedly. This in turn implies that potential political and social tensions will be acutely monitored by Saudi authorities and that budget expenditures have a major in-built constraint.

Collapse in oil prices and ability to absorb: the *cyclical* challenge

The particular context of a modest over-supply, large inventories and convergent expectations for further decline in prices create a situation where prices can collapse "with no floor" until a producer clinches. However, our quantitative models converge in suggesting that 70 $/bl is a near-term target for Brent prices, with a plausible rise to 90-95 $/bl in mid-2015Q2, as a result of faster than expected adjustment in supply and demand.

Here we compute the consequences of two different oil price scenarios for 2015 and 2016, one taking into account our models' view[1], and one assuming an average price of 60 $/bl on average in both 2015 and 2016. Our quantitative approach clearly shows that only a persistently low oil price would create medium-term policy issues for the Kingdom. Here, we focus on the "bottom line" indicators that are most relevant for the Saudi economic and financial risks,

[1] Taking into consideration prices observed in January and early February 2015, and assuming a reversal to 70 $/bl around April and around 90 $/bl in July, we incorporate in our computation an average annual price of 75 $/bl in 2015 and 90 $/bl in 2016

namely fiscal balances and public debt on one side, external accounts on the other side.

Scenarios for Saudi Arabia 2015-2016

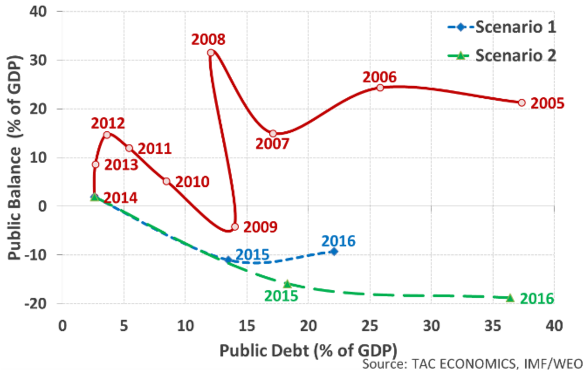
		2014e	2015f	2016f
S1	oil price	99	75	90
	GDP growth	3.6%	2.8%	3.5%
	Fiscal balance*	1.9%	-11.0%	-9.3%
	Public debt*	2.6%	13.5%	22.1%
	Current account*	12.3%	2.9%	7.0%
S2	oil price	99	60	60
	GDP growth	3.6%	2.5%	2.0%
	Fiscal balance*	1.9%	-15.9%	-18.8%
	Public debt*	2.6%	18.3%	36.4%
	Current account*	12.3%	-2.1%	-2.4%

Source: TAC ECONOMICS *: % of GDP

Even in the negative oil price scenario, external accounts would not be any significant issue: the current account would turn from a massive surplus to a deficit of modest proportion (around 2%-2.5% of GDP, i.e. about USD 20 bn each year). This is negligible compared with official fx reserves above USD 700 bn, not including the other foreign assets held by Saudi authorities and the very large fx assets held by the country's financial institutions.

Conversely, the impact on the budget is much stronger, and will undoubtedly create a constraint on both economic and oil policies. In the relatively "favorable" price scenario, the country's ratio of public debt to GDP would increase from less than 3% to above 20%; in the unfavorable price scenario, the same ratio would reach 36% of GDP in 2016. Such levels are not excessively alarming, but Saudi authorities have become keenly aware of their structural need for a large "fiscal buffer" and of the potential constraints related to a public debt that would be too high. Our scenarios would erase almost all the improvement noted over the last decade.

Public Balance and Public Debt
from 2005 to 2016



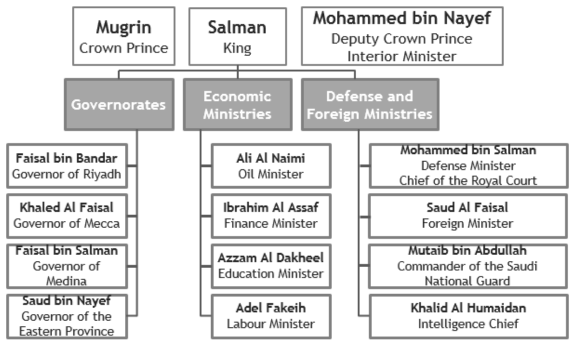
Source: TAC ECONOMICS, IMF/WEO

The conclusions from this analysis are (1) that financial resilience is extremely strong over the next two years, (2) that fiscal constraints would impose a tighter economic policy after 2016 and very probably a change in oil production policy (if not done before) to push towards higher oil prices, and (3) that a failure to restore oil prices closer to the "fiscal breakeven" price (estimated today around 100 $/bl) over the medium-term (i.e. 2016 and after) would sooner or later impose a devaluation of the Saudi Riyal in order to increase the value of oil revenues in local currency (remember that the latest exchange rate adjustment was when oil price plunged in 1986).

Changing the Guard in a highly unstable regional environment: the *political* challenge

Political challenges are indeed many. Internally, the authorities have to deal with the various tensions emerging among various groups of population (with tribal affiliations remaining very strong, religious forces following the strict Wahhabism form of Islam, the emergence of a more westernized middle class, not mentioning the Shia / Sunni division and gender issues). The King also has to deal with the tensions within the Saud family, as very clearly shown by the speed at which King Salman pushed away from government most of the sons of former King Abdullah. King Salman is from the Sudairi line of succession, and he has rapidly reinforced the role and position of two Sudairi princes, his own son Muhammad Bin Salman (aged only 34) and Prince Muhammad Bin Nayef, the very strong Minister of Interior (and second in line for succession)… but who has no son! The current crown prince Muqrin already appears as a likely "weak transition" to the next generation. This arrangement will obviously raise a lot of resentment in the other component of the large royal family.

Simplified Leadership Structure after King Salman's Reshuffle



Last but not least, the number of political challenges on the external front is growing. We provocatively call them the "three nightmares of the Saud", namely (a) the emergence of a strong, democratic and Shia-dominated Iraq, (b) the potential for increasing tensions in the Eastern / oil producing / Shia populated provinces instigated by Iran or Shia fundamentalist groups (including from Yemen), and (c) the re-emergence of Iran or Turkey as the dominant regional powers. Our analysis therefore points to the strategic tolerance of Saudi Arabia for terrorism and chaos in Iraq, the critical role assigned to Egypt in the overall strategic vision of the region by the Saudis, and a likely stronger assertiveness and leadership role in the GCC.

Our global geopolitical view of the Middle East is therefore one of persistent and long-lasting instability. With some of the domestic political fragilities and the negative pressure exerted by lower oil prices, the authorities' ability to manage the political challenge remains by far the largest unknown and uncertainty regarding the medium-term prospects of Saudi Arabia.