MENA ECONOMICS FOCUS

Saudi politics emerges as key economic risk

- **Saudi politics has been a staid affair for decades, but Crown Prince Mohammed bin Salman's launch of an anti-corruption crackdown and his ratcheting up of tensions with Iran herald a period of greater uncertainty. The crackdown is likely to deal a short-term blow to the economy and, further ahead, there is a serious risk of a backlash against the crown prince that brings the Vision 2030 reforms to a grinding halt. While we think the dollar peg will remain intact, Saudi dollar bond spreads are likely to widen.**

- The royal succession in Saudi Arabia has been turned on its head since King Salman came to power in early 2015. Two crown princes have been pushed aside and the king's son, Mohammed bin Salman (MbS), is now heir to the throne. Last month, MbS launched an anti-corruption purge that has implicated more than 200 princes, ministers and businessmen. At the same time, tensions with regional rival Iran have been ratcheted up – MbS stated that Iran's actions in the region are a "declaration of war against the Kingdom".

- The issues at play here are complex and it's difficult to know for sure how all of these events are tied together. **Our sense is that MbS is trying to cement his position ahead of a possible abdication by his father, King Salman**. The anti-corruption crackdown has received strong backing from the Saudi population and follows in the wake of other popular measures, such as the lifting of the ban on women driving. MbS also appears to be trying to shut down dissent from within the royal family.

- **So far, financial markets in Saudi Arabia have taken recent developments in their stride**. Spreads on dollar bonds over US Treasuries did initially jump by as much as 20bp but they have since fallen back. Similarly, the Tadawul equity market has now more than recovered its initial loses. Financial markets elsewhere in the region have generally fared worse than Saudi Arabia's have.

- **However, evidence from other countries that have launched anti-corruption crackdowns suggests that there could be a near-term hit to the economy**. Wealthy Saudis may defer purchases of luxury items as they try to avoid arousing suspicion among the authorities. The speed and breadth of the crackdown is also likely to have stirred fear among investors, and firms might delay investment plans. Perhaps most worryingly, foreign investors – which MbS is courting to support his reform efforts – could well be deterred.

- **Many supporters of MbS have argued that, by consolidating power, he can now push ahead with the economic reforms outlined in Vision 2030**. A crackdown on corruption is clearly welcome given that it has been an impediment to the Saudi economy for some time. **But we are concerned that MbS's power grab could ultimately threaten the Vision 2030 reforms**. The Kingdom is moving further away from the consensus-building that has underpinned policymaking for many decades.

- What's more, MbS's inexperience has already seen him undertake a number of rash and poorly-judged policy decisions. Further slip-ups, combined with opposition from within his own family, run the risk of a backlash that undermines MbS's authority and brings Vision 2030 grinding to a halt.

- **The upheaval in Saudi Arabia could have important spillovers**. In the near-term, any hit to the Saudi economy could dampen growth in neighbouring countries. The ratcheting up of tensions with Iran has already caught Lebanon in the crossfire and the risk of a military confrontation is building. For now, the threat of a direct conflict between Saudi Arabia and Iran seems low, but a fresh proxy war is possible.

- Some have raised concerns that the upheaval could prompt a wave of devaluations in the region, reflected in a weakening of forward exchange rates. Fears over dollar pegs in the Gulf are overdone, although we share the market's concerns about the sustainability of the Lebanese pound. **Moreover, we think the relatively muted response in Saudi financial markets to recent events is somewhat sanguine and that, ultimately, spreads on the Kingdom's dollar bonds are likely to widen again.**

Jason Tuvey, Middle East Economist, +44 (0)20 7808 4065, jason.tuvey@capitaleconomics.com

Saudi politics emerges as key economic risk

Saudi politics has been a staid affair for decades, but Crown Prince Mohammed bin Salman's launch of an anti-corruption crackdown and his ratcheting up of tensions with Iran herald a period of greater uncertainty. In this *Focus*, we argue that the crackdown is likely to deal a short-term blow to the economy and, further ahead, there is a serious risk of a backlash against the crown prince that brings the Vision 2030 reforms to a grinding halt. While the dollar peg should remain intact, Saudi dollar bond spreads are likely to widen.

Succession shake-up

The royal succession in Saudi Arabia has been turned on its head since King Salman came to power in early 2015. Since the death of the founder of the modern Saudi state, Ibn Saud, in 1953, the throne has been passed between his sons. Upon his accession to the throne, King Salman looked set to maintain this tradition as Prince Muqrin (the youngest of Ibn Saud's sons and who was deputy crown prince at the time) was elevated to the position of crown prince (i.e. heir to the throne).

Within the space of a number of months, however, Prince Muqrin was replaced as crown prince by his nephew and, at the time, Interior Minister Prince Mohammed bin Nayef. He had appeared to be on course to become the first of the grandsons of Ibn Saud to accede to the throne.

But there was another twist in the succession shake-up as it became increasingly clear that King Salman was trying to clear the path for his son, Mohammed bin Salman (known as MbS), to become heir. MbS was appointed deputy crown prince in April 2015. And in June this year, the reshuffle was complete as MbS replaced Mohammed bin Nayef as crown prince.

Mohammed bin Salman's rise up the royal ladder has been accompanied by an accumulation of substantial policymaking powers. He now controls all of the Kingdom's security and defence operations as head of the Council of Political and Security Affairs. And, as chair of the Council of Economic and Development Affairs, he was the key architect of the Vision 2030 reform plans.

Most recently, King Salman appointed his son to head up a new committee to oversee investigations into public corruption. The new committee acted quickly and, in a frenzied set of events on 4th November, arrested more than 200 ministers, princes and elite businessmen on allegations of corruption. Those detained are currently being held at various luxury hotels in Riyadh, including the Ritz Carlton – where MbS played host to high-profile investors at the Future Investment Initiative conference only a week earlier.

A formal list of those arrested has not been released by the authorities, but is reported to include prominent investor Prince Alwaleed bin Talal, former finance minister Ibrahim al-Assaf and recently-dismissed head of the National Guard, Prince Miteb bin Abdullah. According to reports, the detainees are being offered their freedom in return for handing over a substantial portion of their assets to the government. In a recent interview with the *New York Times*, MbS said that 95% of those currently being detained have agreed to a settlement and the Saudi public prosecutor has said that these could raise as much as $100bn in revenue and assets for the government.

At the same time as launching the anti-corruption drive, MbS has ratcheted up tensions with regional foe Iran. A thwarted missile strike on Riyadh airport by Yemen's Houthi rebels – which are supported by Iran – prompted MbS to state that Iran's actions in the region are a "declaration of war against the Kingdom". MbS has also decried the Lebanese government as being beholden to the Iran-backed group, Hizbollah.

MbS consolidating power

The issues at play here are complex and it's difficult to know for sure how all of these events are tied together. **Our sense is that MbS is trying to cement his position ahead of a possible abdication by his**

father, King Salman. There are two main strands to MbS's approach.

First, he is trying to boost his popularity among the Saudi population. Corruption has been thrust into the spotlight as Saudi citizens have sought to highlight the excesses of the ruling elite during a period of austerity and economic weakness. As a result, the anti-corruption crackdown has garnered strong support among the Saudi population and follows in the wake of other measures, such as the lifting of the ban on women driving, that have been particularly popular among the Kingdom's large youth cohort. MbS appears to be trying to repair the damage to his reputation caused by the cuts to civil service bonuses late last year – these cuts were reversed in April this year following a public outcry on social media.

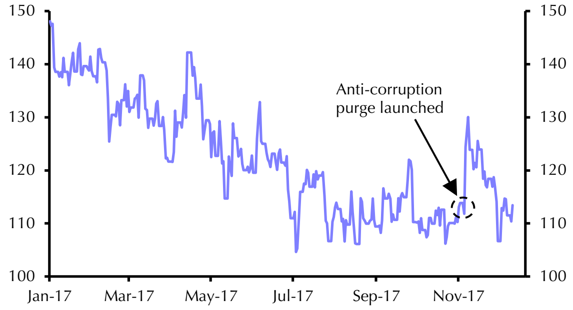
Second, MbS seems intent on shutting down dissent from within the royal family. We've noted before that MbS does not appear to have the full support of his family. Three of the 31 members of the Allegiance Council – which represents the various branches of the royal family and has the final say over changes to the succession – refused to back MbS's elevation to crown prince. There may be others that are also opposed to his climb up the royal ladder but are hesitant to voice their resistance. The fact that details of the events leading up to and following MbS's promotion to crown prince were leaked suggests that some in the Kingdom, either in the royal family or close to it, may be trying to stir up discontent.

MbS's drive to clamp down on dissent has been highlighted by the dismissal and arrest of head of the National Guard, Prince Miteb bin Abdullah. Prince Miteb – who was once tipped to be a future king – and the National Guard, had for some time been touted as a source of opposition towards MbS.

Mixed market reaction

So far, financial markets in Saudi Arabia have taken recent developments in their stride. Spreads on dollar bonds over US Treasuries did initially jump by as much as 20bp. But they have since fallen back and are now roughly in line with their level prior to the launch of the anti-corruption purge. (See Chart 1.)

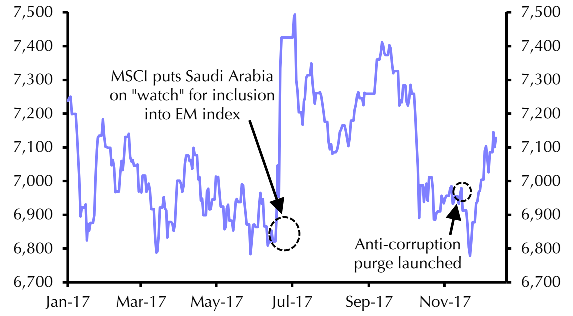
Chart 1: Saudi 2026 Dollar Bond Spread over 10-Year US Treasuries (bp)



Sources: Thomson Reuters, Capital Economics.

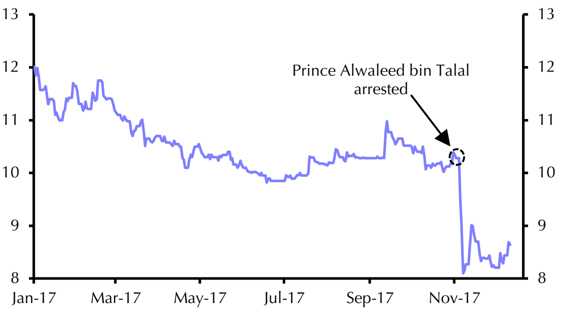
Similarly, the Tadawul equity market has now more than recovered its initial losses. (See Chart 2.) Shares of companies owned by those implicated in the corruption allegations have, unsurprisingly, suffered heavily. For example, the share price of Kingdom Holding Group – the conglomerate owned by Prince Alwaleed bin Talal – has slumped by more than 15%. (See Chart 3.)

Chart 2: Tadawul Equity Index



Sources: Thomson Reuters, Capital Economics.

Chart 3: Share Price of Kingdom Holding Group (SAR)

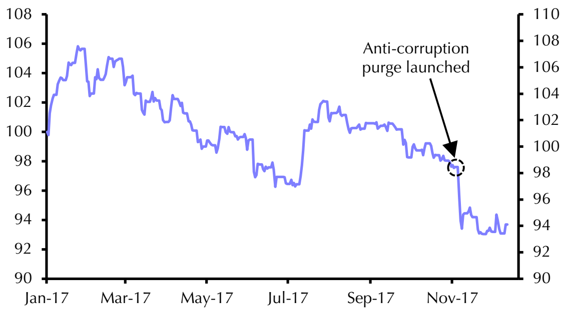


Sources: Thomson Reuters, Capital Economics.

Shares of other firms, however, have performed better. This may simply reflect the recent jump in oil prices, but there are also hopes in some quarters that a consolidation of power by MbS means that he will now be able push ahead with his economic reforms. (More on this later.)

Financial markets elsewhere in the region have generally fared worse than those in Saudi Arabia. (See Chart 4.) The MSCI Arabian Markets (excluding Saudi Arabia) Index is still down by 4% since the launch of the Saudi anti-corruption campaign, whereas the Tadawul is now *up* by 2.5%. Investors appear to have been spooked by the Kingdom's increasingly aggressive tone towards Iran and the threat that this could morph into some kind of military confrontation.

Chart 4: MSCI Arabian Markets (ex. Saudi Arabia) (1st Jan. 2017 = 100)



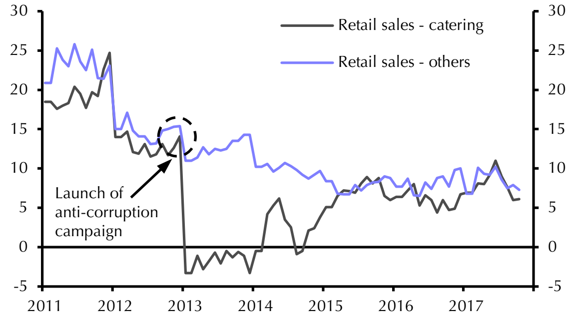
Sources: Thomson Reuters, Capital Economics.

Economy may take a hit

In terms of the broader economic impact, evidence from other countries that have launched anti-corruption crackdowns suggests that there could be a near-term hit to the economy. The most prominent example is China. Shortly after becoming president in 2012, Xi Jinping unveiled a range of new rules aimed at reducing graft, including limits on official dinners and a ban on officials from accepting lavish gifts. In addition, more than 1.3 million civil servants have been disciplined for alleged graft.

The most noticeable impact that the campaign had on the Chinese economy was a fall in the consumption of high-end goods and services. As Chart 5 shows, sales from large catering firms slumped in early 2013 as officials cut back on extravagant parties. Sales of jewellery, Maotai (a high-end liquor) and mooncakes (a traditional dessert) also suffered. (See our *China Economics Update*, "Drag on growth from anti-graft measures easing", 4th December 2015.)

Chart 5: Chinese Retail Sales by Large Firms (nominal, % y/y, average for Jan. and Feb.)



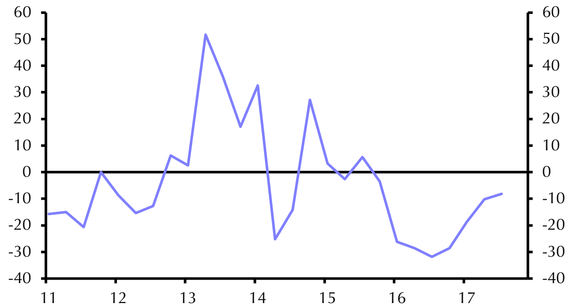
Sources: CEIC, Capital Economics.

We could witness a similar pull back in purchases of luxury items by wealthy Saudis as they try to avoid arousing suspicion among the authorities. The impact on overall GDP growth would be partially offset by weaker imports, as most of these goods are imported from abroad. But there would still be a knock-on effect on economic activity that causes growth to weaken.

There's very little evidence available at this stage to estimate the economic fallout so far. The whole economy PMI – which covers the non-oil private sector – jumped to a two-year high in November, but more than anything that probably reflects a boost to sentiment from higher oil prices.

We will be looking closely at a number of other data sources over the coming weeks and months to gauge the impact. For example, the World Gold Council produces timely quarterly data on consumer demand for gold in Saudi Arabia. (See Chart 6.) Import data may also provide some clues to the extent of weakness in domestic demand.

Chart 6: Saudi Consumer Demand for Gold (% y/y)

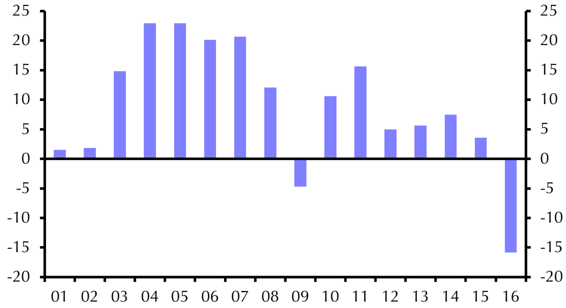


Sources: World Gold Council, Capital Economics.

The anti-corruption crackdown may also harm investment – which contracted by 15.9% last year.

(See Chart 7.) The speed and breadth of the crackdown is likely to have stirred fear among investors and firms might delay investment plans as they await to see if they will get caught up in the allegations.

Chart 7: Gross Fixed Capital Formation (% y/y)

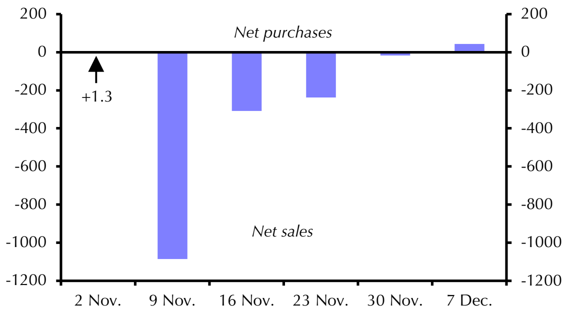


Sources: CEIC, Capital Economics.

Perhaps most worryingly, foreign investors – which MbS is courting to support his reform efforts – may be deterred given the added uncertainty and the fact that many companies rely on partnerships with firms owned by those being detained to establish their operations in the Kingdom.

There is some early evidence that foreign investors have been spooked by recent events. For example, foreign (non-GCC) investors have been net sellers of Saudi stocks for four out of the past five weeks. (See Chart 8.)

Chart 8: Net Purchases of Saudi Stocks by Foreign Investors (Week Ending, SARmn)



Sources: Tadawul, Capital Economics.

There could be a number of other potential effects. Officials may be reluctant to approve construction projects for fear of being tied to corruption claims. **A period of capital flight is also a risk**. Admittedly, the government has already passed bank account details of those detained on to the monetary authority, SAMA, in an attempt to prevent those individuals shifting their assets abroad. But concerns about expropriation of assets could prompt other firms and individuals to take their money out of the Kingdom. Indeed, banks in Switzerland have reported suspicious activity on the accounts of some of their Saudi clients. Capital outflows would force SAMA to intervene more heavily in the foreign exchange market in order to maintain the dollar peg, thus forcing it to draw down its FX reserves.

What does all of this mean for economic reforms?

Many supporters of MbS have argued that, by consolidating power, he can now push ahead with the economic reforms outlined in Vision 2030. The overarching aim of these reforms is to reduce the government's dependence on oil receipts and kick-start the development of the non-oil sector.

A crackdown on corruption is clearly welcome given that it has been an impediment to the Saudi economy for many decades. This has been evident in a number of different areas. One is that individuals and businesses are forced to rely on an army of "brokers" to cut through the convoluted bureaucracy. These brokers have privileged access to ministers or those in high-level positions within the government. (This is known in the Kingdom as *wasta*, loosely translated as "who you know".)

Another is that small and medium enterprises in the non-oil sector have struggled to compete against large firms that have prospered due to their close relationships with the royal family. Indeed, SMEs make up a smaller share of the economy in Saudi Arabia, around 33%, compared with other major economies.

However, we are concerned that MbS's power grab could ultimately threaten the Vision 2030 reforms. For one thing, the Kingdom is moving further away from the consensus-building that has underpinned policymaking for many decades. This is likely to ruffle more feathers within the royal family as well as those tied closely to it, such as the religious establishment and the business elite.

What's more, MbS's inexperience has already seen him undertake a number of rash and poorly judged policy decisions. As Defence Minister, he was primarily responsible for the decision to enter the conflict in Yemen. According to recently-leaked emails, MbS now wants out of what many would argue has been a disastrous campaign.

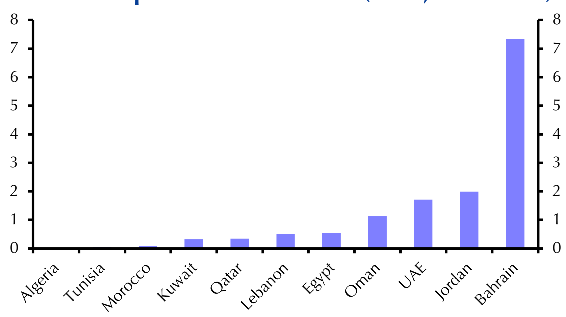
He was also reportedly behind the diplomatic crisis with Qatar, which has reached an impasse and led to international condemnation of Saudi Arabia and its allies. Prince Mohammed bin Nayef's reported opposition to the move is said to be one reason why his removal as crown prince came about more quickly than many had anticipated.

So far, MbS's apparent policy missteps don't appear to have prompted a significant build-up of opposition. **But further slip-ups, combined with opposition from within his own family, the business elite, the religious establishment and the civil service, run the risk of a backlash that undermines MbS's authority**. In a scenario where MbS is pushed aside, the Vision 2030 reform plans would probably grind to a halt. This would dash hopes that Saudi Arabia might significantly reduce its reliance on oil and that the country's long-term economic growth prospects will improve.

Fallout for the rest of the region

As the region's largest economy and political heavyweight, the upheaval in Saudi Arabia could have important spillovers. **In the near-term, any hit to the Saudi economy could dampen growth in other parts of the region**. After all, the Kingdom is a significant export destination for a number of countries, particularly Bahrain, Jordan and the UAE. (See Chart 9.)

Chart 9: Exports to Saudi Arabia (2016, % of GDP)



Sources: Thomson Reuters, Capital Economics.

There are also potential political ramifications. **The ratcheting up of tensions with Iran has already caught Lebanon in the crossfire and the risk of recent developments morphing into some kind of military confrontation is building.**

For now at least, the threat of a direct conflict between Saudi Arabia and Iran seems low. Instead, the most likely scenario is that all of this is played out through another proxy war – with Lebanon likely to be centre ground.

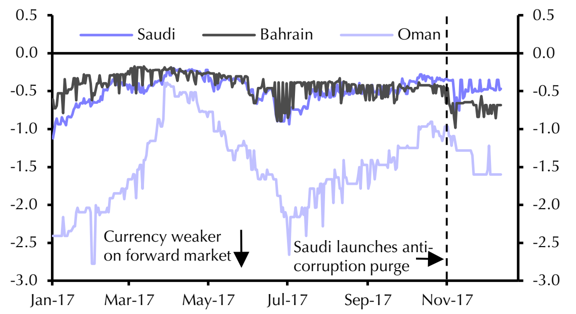
If this came to fruition, this would clearly have devastating social and humanitarian implications for Lebanon. Moreover, a period of capital flight could ultimately force the Lebanese authorities to abandon the dollar peg, which could create problems for the government in servicing its large foreign currency debts. (See our *Updates*, "Lebanon's dollar peg under threat as tensions mount", 7th Nov and "A closer look at Lebanon's FX debt burden", 17th Nov.)

The risk of a conflict in Lebanon causing disruptions to economic activity in the rest of the region is limited, but at the very least it may dent business and consumer confidence.

Gulf dollar pegs to stay, but additional risk premia

The upheaval has also raised fresh fears over the sustainability of the region's dollar pegs. This has been reflected in a jump in forward exchange rates in Lebanon and several Gulf countries, including Saudi Arabia, Bahrain and Oman. (See Chart 10.)

Chart 10: Difference Between Spot and 12m Forward Exchange Rates (%)



Sources: Thomson Reuters, Capital Economics.

For the reasons mentioned above, we share the market's concerns about the sustainability of Lebanon's currency peg. But we think fears that the Gulf countries will abandon their dollar pegs are overdone. Low oil prices have opened up twin budget and current account deficits, but after several years of fiscal consolidation, these are now relatively small in most countries.

Balance sheets in the Gulf are also strong. FX savings are large – equal to as much as five times GDP in some cases. Government debt levels are typically low too so sovereigns can easily raise external financing if necessary. And ironically, in so far as recent tensions have triggered capital flight, the impact is likely to have been at least partially offset by the boost from higher oil prices.

Admittedly, Bahrain and Oman are vulnerable to a devaluation. Balance sheets there are much weaker than in the rest of the Gulf. Crucially, though, both countries can probably rely on their neighbours for financial support to stave off devaluations. This is a route that is almost certainly closed off to Lebanon.

That all said, we think the relatively muted response in Saudi financial markets to recent events looks somewhat sanguine. Ultimately, we think spreads on the Kingdom's dollar bonds over US Treasuries will widen again as investors start to demand an extra premium to compensate for the greater level of political uncertainty, particularly if any clear signs start to emerge that internal opposition towards MbS is building.


TORONTO
NEW YORK
LONDON
SINGAPORE
SYDNEY