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Implications of the Iran-Saudi Arabia Détente

In early March, [China brokered a thaw](#) between Iran and the Kingdom of Saudi Arabia (KSA). The two countries have been at odds for decades, even before the Iranian Revolution in 1979. Essentially, both nations believe themselves to be the rightful leader of the region. The nations had been allied during the reign of the Iranian Shah under U.S. auspices, but after the revolution, the U.S. broke off ties with Iran and that break remains to this day. The KSA has seen relations with Iran change over time, where sometimes they are improving and at other times they are at odds. Before this most recent thaw, the KSA had [broken off relations with Iran in 2016](#) in retaliation for violent protests directed toward Saudi embassies due to the execution of a Shiite activist by the KSA.

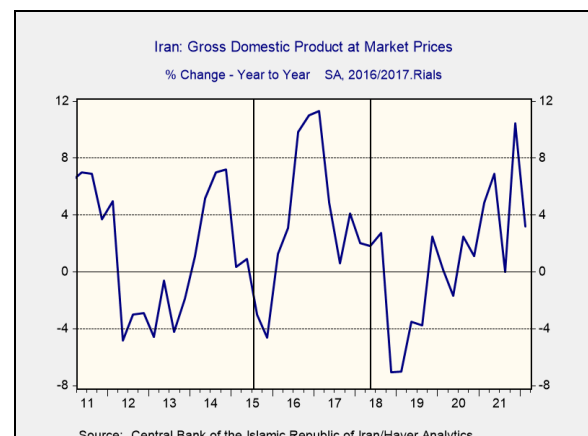
The decision to improve relations, especially under the guidance of Beijing, is noteworthy. In this report, we will begin with why this attempt to improve relations has occurred now. From there, we will examine the geopolitical implications that the improved relations could bring. At the same time, as we noted above, Iran and the KSA have been in opposition for a long time, so an assessment of how far this thaw will go is also important. We will conclude with market ramifications.

Why Détente Now?

On its face, this question has a simple answer. Both Iran and the KSA are facing

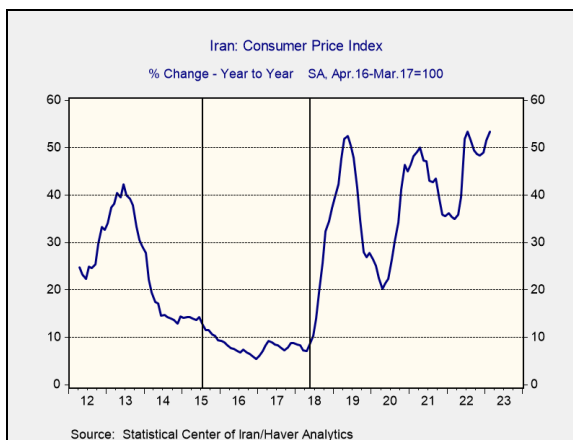
problems difficult enough that the cost of keeping relations severed has become too high.

In May 2018, [President Trump ended U.S. participation](#) in the Joint Comprehensive Plan of Action (JCPOA), known colloquially as the Iran nuclear deal. The Obama-era plan was designed to freeze Iran's nuclear weapons development in return for sanctions relief. The agreement was controversial as the Arab states and Israel strongly opposed the program, fearing that ending sanctions would allow Iran to expand its influence in the Middle East. Obama knew that the JCPOA would [never have a two-third's majority in the Senate](#), the hurdle for a treaty. Thus, it was merely an agreement that could be rescinded by future U.S. administrations. The lack of a treaty reduced the attractiveness of Iran to foreign investors. There was an initial sharp rise in GDP after the JCPOA went into effect, but growth subsequently slowed. Then, as the chart below shows, after the U.S. withdrew from the plan, Iran's economy suffered from the reimplementation of sanctions.



We have placed vertical lines showing when the JCPOA was implemented and when the U.S. withdrew. The selling point for Iranian President Rouhani, whose administration negotiated the deal, was that the economic recovery would justify the restrictions on the nuclear weapons program. For the most part, sanctions relief was modest at best, and the Iranian regime was generally disappointed with the outcome. Trump's decision to exit the program confirmed the tenuous nature of the agreement without a backing treaty. And so, when President Biden attempted to return to the JCPOA, Iran made a series of demands, the most important being that the U.S. wouldn't leave it again. Since the Biden White House couldn't provide that assurance, negotiations, to date, have been fruitless.

Although Iran has learned to live with the sanctions, they still hurt its economy. Iran's official inflation is running at 53.4%.



It is evident that the return to sanctions from the U.S. has caused a jump in prices. Iran's exchange rate has been in a [free-fall](#); the official rate is 42,000 IRI/USD but the market rate is [usually above 500,000 IRI/USD](#).

Complicating matters further for Iran is that it has been facing serious internal unrest. Last September, [Mahsa Amini](#), a 22-year-

old Kurdish woman, died in custody when she was being held on violating hijab (head covering) rules. In the aftermath of her death, widespread protests emerged, and the regime, as it usually does, cracked down hard on the unrest and is [still trying to enforce the hijab rules](#) with growing opposition.

Meanwhile, the KSA has a desire to extricate itself from the [Yemen Civil War](#) which it has been involved in since 2014. Iran has been supporting the Houthis, whom the KSA opposes. The Saudis probably cannot exit the conflict as long as Iran is giving help to the Houthis.

Essentially, both Iran and the KSA have something to gain from improving relations. However, there was little evidence that the two countries, on their own, could end the impasse. The usual interlocutor in the region, the U.S., was ill-positioned to play a mediating role. Washington hasn't had official relations with Tehran since 1979 and relations between the U.S. and the KSA have been cool since candidate, and now president, Biden indicated that he wanted to make the de facto leader of the KSA, Crown Prince Salman, a pariah. Although the [president attempted to improve relations](#), as we noted in our recent [petroyuan report](#), that mission was not successful.

China, in contrast, has generally good relationships with both the KSA and Iran. Beijing has mostly ignored Western sanctions on Iran and has been a [major consumer](#) of Iranian oil exports. [China](#) has also been deepening economic ties with the KSA and is the [KSA's largest trading partner](#). Thus, when Beijing facilitated talks between Iran and the KSA, they were inclined to treat China as a "fair broker." Iran and the KSA agreed to restore diplomatic relations, which includes

reopening embassies and reactivating a security cooperation agreement.

In summary, both Iran and the KSA have goals that are more likely to be achieved after this détente. For Iran, its economy is in terrible shape, so the agreement will likely improve regional trade and help Tehran ease the pressure from sanctions. The KSA hopes to end hostilities in Yemen, and [talks have already started](#). The Houthis are more likely to negotiate if they lose support from Iran.

Winners and Losers

United States: The U.S. fostered a special relationship with the KSA in 1945, when Ibn Saud, the founder of Saudi Arabia, [met with President Roosevelt on the USS Quincy on the Red Sea](#). The U.S. wanted to compete with European powers for the region's oil reserves and the solidifying of relations with Saudi Arabia was a key element of that goal. Since this historic meeting, relations between the KSA and the U.S. have held together, although not always smoothly. A perennial sticking point has been relations with Israel. The U.S. supported the Jewish state, something that Ibn Saud generally opposed. U.S. aid to Israel during the Yom Kippur War in 1973 triggered an Arab oil embargo that sent oil prices soaring. However, in the aftermath of that war, Washington and Riyadh agreed that, in return for American security support, the KSA [would price oil in dollars](#). As the KSA then accumulated dollars, it tended to recycle them into Treasuries, creating the petrodollar system.

Although Nixon didn't necessarily guarantee KSA security, over the years, the promise mostly evolved into just that. The [Carter Doctrine](#) committed the U.S. to defending the Gulf region from outside powers, deeming the area to be a vital American

interest. During the Iran-Iraq War, the U.S. [reflagged oil vessels](#) to protect oil flows from the belligerents. Perhaps the clearest expression of the Persian Gulf and the KSA being of vital interest to the U.S. was when America led a coalition against Iraq to liberate Kuwait in 1990-91. Iraq's presence in Kuwait raised fears that Saddam Hussein would try to take control of Saudi oil assets by invading the kingdom.

However, as [Lord Palmerston remarked](#) in 1848, nations only have perpetual interests, not allies. The attacks on 9/11 had significant Saudi citizen involvement. There were concerns in the U.S. that Saudi religious support was fostering Islamist terrorism. The Saudis were not happy with the invasion of Iraq, which replaced a mostly Sunni nation with a Shiite one dominated by Iran. Riyadh opposed the JCPOA, fearing it would increase Iranian influence in the region. The lack of response to President Obama's "red lines" tied to Syrian deployment of chemical weapons further damaged U.S.-KSA ties. Although the KSA made a strong attempt to rebuild relations with Washington during the Trump years, the lack of response to the [Houthis' attack on the oil facilities at Khurais and Abqaiq in 2019](#) further soured relations. The Saudis wanted a muscular response from Washington, and that didn't occur. Instead, the U.S. [added more sanctions on Iran](#). As noted earlier, one of President Biden's campaign promises was to treat Crown Prince Salman as a pariah for his role in the murder of journalist Jamal Khashoggi.

For the U.S., the Middle East is simply less important. First, the development of fracking has dramatically lifted U.S. oil production, making America less dependent on Middle Eastern oil. Contributing to that independence is that Canadian oil flows are mostly captured by the North American

pipeline system. Thus, U.S. oil needs are less dependent on the Middle East. Second, expectations of future oil needs are expected to be less due to the expansion of renewables. Third, the U.S. views China as a strategic competitor and thus wants to focus less on the Middle East and more on the Far East. During the Obama administration, the idea was to “pivot to Asia.” We believe the JCPOA was expected to be the first step in normalizing U.S.-Iranian relations with the idea that Iran would become the regional hegemon. This policy was an anathema to the Arab states and Israel, but it would free the U.S. to focus elsewhere.

U.S. actions since 2008 indicate that the Carter Doctrine is no longer in force. This decision has created a [power vacuum that China appears to be trying to fill](#).

China: Facilitating the Iran-KSA détente is a major diplomatic win for Beijing, but one that might be more costly than China realizes. As we noted previously, Iran and the KSA were at a point where both sides had good reason to improve relations. China’s timing was good.

As we examined in our [petroyuan report](#), China is trying to build an alternative to the U.S. dollar system and is using the Shanghai Cooperation Organization, which the [KSA is taking steps](#) to join, as a building block. Helen Thompson observed that China viewed the Iraq invasion as evidence that the U.S. was trying to control Middle Eastern oil supplies.¹ The U.S.’s decision to reduce its influence in the Middle East must have looked like a golden opportunity to China, and it may be. However, as the U.S. experience shows, it’s a hard region to

maintain. The U.S. has extensive military facilities in the region and is constantly being dragged into regional conflicts. Beijing probably doesn’t have the capabilities to project the power needed to stabilize the Middle East as well as deal with the American pivot to Asia.

To be successful, China will need to manage the region mostly through diplomatic means, but this recent success may be a one-off. The costs could rise in the future.

Europe: Perhaps the biggest loser in this détente is Europe. As we noted in our petroyuan report, the age of oil has not treated the Continent well. Due to its lack of ample oil and gas reserves, Europe will most likely always be dependent on outside suppliers. Since colonization is no longer an option, the EU has tried to address energy security with multiple suppliers. The war in Ukraine has highlighted the cost of being dependent on Russian supplies, leaving the U.S. and the Middle East as the key suppliers. As long as the U.S. provided security to the Middle East, a dependence on that region wasn’t all that risky. But, if the U.S. is leaving and China is moving in, China could attempt to influence Middle Eastern oil producers into prying the EU away from the U.S. For example, the Middle Eastern oil producers could demand payment in CNY, forcing Europe to maintain trade relations with China.

Israel: If Europe is the biggest loser in the Iran-KSA détente, Israel might be a close second. The goal of the Abraham Accords was to create an anti-Iran coalition. For example, one of the impediments to an Israeli air assault on Iran’s nuclear facilities is that it needed to avoid Saudi airspace. If the Saudis and Israel normalized relations, it would be more likely that Israel could overfly Saudi Arabia. Ideally, if Israel could

¹ Thompson, Helen. (2022). *Disorder: Hard Times in the 21st Century*. Oxford, U.K.: Oxford University Press, page 73.

use KSA airbases, then the ability to run multiple sorties would increase. This détente with Iran reduces Riyadh's need to normalize relations with Israel and weakens the chances for an anti-Iran coalition.

Russia: Russia probably benefits from this détente. Being an ally of China, anything that helps China should be supported by Russia. However, there are some downsides for Moscow from this agreement. First, China may decide it needs to buy more crude oil from the Middle East to build its power projection in the region. If Russia sees less Chinese demand, then finding its replacement might be difficult. Second, Beijing may prefer lower oil prices. If so, China might pressure the Gulf producers to lower the OPEC+ target price.

What about Iran and the KSA?

The KSA: Crown Prince Salman is clearly unhappy with how the U.S. is treating him, personally, and the kingdom, in general. Thus, he is willing to undermine the petrodollar system and “make new friends.” If the U.S. is moving away from its involvement with the region and the kingdom, then building new relationships is probably necessary.

However, we think this détente with Iran is likely temporary. The KSA opposes Iran's power projection in the region. Improving relations to end the Yemen Civil War at this time makes sense, but there are few areas where cooperation between Tehran and Riyadh are likely. At some point, tensions will likely return. It isn't clear whether China has the power projection capacity to stop Tehran if it tries to cause trouble in the region. In other words, relying on China might not be wise.

During the Cold War, it was common for non-aligned nations to “play both sides” of

the war for investment and other favors. It appears that the Crown Prince is trying to build room to maneuver. As we note above, the U.S., through the Abraham Accords, was trying to build an anti-Iran coalition in the region. The Saudis haven't given up on the idea, but want a [full security guarantee](#) from the U.S. to normalize relations with Israel. We doubt the U.S. will make such an offer given Washington's goal of reducing its involvement in the region.

Iran: Similar to the KSA, Iran was in a place where it needed to reduce pressure. Avoiding one less enemy in the region makes sense. Still, its long-term goal in the region is hegemony. This détente doesn't change that. Of course, China's goal is harmony so oil flows to China will continue unabated. Beijing will likely pressure Tehran to reduce its aggression in the region; it remains to be seen if it will be successful.

Ramifications

In some respects, the KSA-Iran détente is an element of the emerging petroyuan system. As China attempts to build an alternative currency system based on gold and natural resources as reserve instruments, extending relations with commodity producers is a logical step in that goal. Proving to the Gulf region that China can make a difference in improving security through its diplomacy supports that effort.

On its face, anything that reduces tensions in the region is probably bearish for oil prices. However, this idea does face the problem of “whose oil price?” If China is able to pay for its oil imports in CNY, it might engineer a lower price compared to dollar buyers, or it could “encourage” Persian Gulf producers to prioritize sales to China over the rest of the world.

For a long time, the Saudis defended their share to the U.S. market. The shale revolution ended that defense, but it could become a factor in Chinese sales. In other words, the KSA may decide it will command the largest share of China's import market and raise supplies to achieve that goal. In the past, that led to lower global oil prices. That may not be the case going forward if the oil market fractures due to the emergence of blocs. We will also be watching to see if China's inroads into the Middle East allow it to

expand its arm sales to the region at the expense of the U.S. and Europe. At this juncture, there is no evidence this is occurring. It does bear close monitoring, though, especially if China is willing to sell the most advanced weapons to the Arab states, something that the U.S. has generally avoided.

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