Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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The Saudi Tribulation

On October 18th, Saudi King Abdullah's government announced that his kingdom would reject an invitation by the U.N. Security Council to occupy a seat on the council. This rejection is the first in the history of the United Nations and occurred after Saudi diplomats had worked diligently to garner the invitation. The rejection came as a surprise to the U.N. and to the U.S.

According to reports, King Abdullah decided to reject the seat due to the Security Council's "double standards." He argued that the inability to resolve the Palestinian issue, prevent the proliferation of WMD and stop the Syrian regime from killing its citizens as reasons for the refusal to accept the post. However, these factors are generally thought to be excuses. Instead, the Saudi regime, incensed at U.S. policy decisions, rejected the seat as a way to express the kingdom's displeasure with the American government. We note that Turkey and Egypt, also unhappy with recent decisions by the Obama administration, supported the kingdom's decision.

In this report, we will discuss the basic history of U.S. and Saudi relations, focusing on the historical commonality of goals between the two nations. We will detail how the aims of the two nations have diverged since the Cold War ended and use this to examine America's evolving plans for the Middle East. We will discuss how the evolution of U.S. policy is affecting Saudi Arabia and the pressures these changes are bringing to the kingdom. As always, we will conclude with market ramifications.

A History of American-Saudi Relations

King Ibn Saud, the founder of Saudi Arabia, and President Roosevelt met on Valentine's Day, 1945, aboard the USS *Quincy* on the Great Bitter Lake section of the Suez Canal. This meeting laid the groundwork for an enduring relationship between two unlikely powers, the world's leading democracy and an autocratic kingdom. Although the two powers had little in common, they were unified by common goals. The U.S. wanted to secure the Middle East's oil production potential for the West and the Saudis wanted protection from the growing communist threat and from the European colonial powers.

Despite the fact that the U.S. was the world's largest oil producer at the time, the British had made large oil discoveries in Iran and geological surveys suggested that similar fields were likely to be found in other parts of the region, including what is now Iraq and the Saudi kingdom. In fact, massive fields were found and by the early 1970s, the region became the key global oil supplier.

Over time, the relationship between the U.S. and Saudi Arabia evolved. The Saudis were a key member of OPEC; the cartel, angry at Western support for Israel during the 1967 Six-Day War, declared an oil embargo. As the Arab producers cut output, the U.S. simply lifted production, rendering the embargo impotent.

This was not the case during the 1973 Yom Kippur War. The Nixon administration, fearful that Egypt was about to overrun Israel, resupplied the Jewish state with a massive airlift. In response, the Saudis led another oil embargo. Unlike the situation in 1967, the restriction of oil supplies led to dramatic increases in oil prices. The rise in oil prices contributed to a deep recession in the U.S. Although the embargo was considered by most historians to be a failure, because eventually oil supplies were replenished and U.S. relations with Israel were unaffected by the embargo, the power of Arab OPEC was now obvious to the world.

Despite ongoing disagreements on the Palestinian issue and the state of Israel, both nations needed each other. The U.S. needed access to the region's oil; modern warfare requires access to petroleum and given that the Saudis are a major (and very low cost) producer, American security rested on the region's oil supplies. In addition, winning modern wars not only requires access to oil, but it also requires denying access to potential enemies. These conditions led to the "Carter Doctrine" where President Carter, at his 1980 State of the Union Address, proclaimed that the U.S. would use military force to defend its national interests in the Persian Gulf. This proclamation was done to make it abundantly clear to the Soviet Union that the U.S. would not allow them to seek influence in the region.

For the Saudis, the U.S. offered protection not only against Communism but also from regional threats. The Iranian Revolution in 1979 removed the Shah and, in its place, a radical Shiite government was formed. Iran's revolutionary government was seen as a direct threat to the Sunni Gulf states as Ayatollah Khomeini promised to expand his Islamic government into new territories.

In 1986, Saudi Arabia, acting as swing producer for OPEC in order to keep prices elevated, had seen its market share decline. The kingdom tried to sway the cartel into lowering overall production, but mostly failed as virtually all the world's oil producers benefited from Saudi restraint. Saudi Arabia, who had traditionally been either the largest or second largest supplier of oil to the U.S., fell to 11th place in this period. In order to defend its market share, the Saudis boosted production, prompting a collapse in oil prices. The decline, from the $30 per barrel level to under $10, played havoc on global oil markets. Eventually, Vice President George Bush convinced the Saudis to cut output to allow prices to rise back toward $20 per barrel to stabilize the oil industry.

Saudi contributions to undermining the Soviet Union were important as well. The aforementioned drop in oil prices severely hurt the Soviet economy and was one of the precipitating events that led to the dissolution of the Soviet Union. In addition, Saudi support for jihadists operating in Afghanistan contributed to the Soviet's ignoble retreat from that central Asian nation.

Another major regional threat was made evident in August 1990 when Saddam Hussein invaded Kuwait. The Persian Gulf kingdoms all share one key characteristic—they have high oil reserves to population ratios which make them attractive targets for regional powers and hard to defend. Iraq's invasion of Kuwait made that risk abundantly clear. The U.S. moved quickly to protect eastern Saudi Arabia from a potential Iraqi invasion and, in the coming months, liberated Kuwait. U.S. actions showed that the Carter Doctrine remained a key part of American foreign policy.

The Post-Cold War Situation

The end of the Cold War did not initially cause major changes in U.S.-Saudi relations; the Saudis remained concerned about Saddam Hussein but were equally worried that his ouster could boost Iran's regional standing. The Clinton administration's "no-fly zones" and various sanctions prevented Iraq from projecting power but did leave the regime in place.

However, this stability began to unwind after the terrorist attacks against the U.S. on 9/11. For the Saudis, the attacks were a major embarrassment, as 15 of the 19 terrorists were Saudi nationals. The Bush administration's war on terrorism affected Saudi Arabia in several ways. First, the Saudis had used the Soviet-Afghan War to fund jihadists that could have eventually developed into a proxy force similar to Iran's Hezbollah. However, this hope ended when Osama bin Laden declared the use of U.S. forces to defend the kingdom in 1990 as illegitimate. After 9/11, all jihadists groups were considered a threat, meaning the Saudi kingdom could no longer support them. As a result, these groups turned on the Royal Family which led to an insurgency within Saudi Arabia. Second, the Bush administration viewed the authoritarian regimes as fostering the development of jihadists and pressed the powers in the region to democratize. Democracy was seen as a threat to these authoritarian governments and strained ties with the U.S. Third, the U.S. decision to invade Iraq was strongly opposed by Saudi Arabia, which (correctly, we might add) worried that removing Saddam Hussein would create a power vacuum that would be filled by Iran. Fourth, the Obama administration's decision to undermine support for Hosni Mubarak infuriated the Saudis as it allowed a competing version of Islamic government to be installed in an important Arab state. The Obama administration's mild opposition to Morsi's removal by the military has not been welcomed either.

What Has Changed?

In part, after the Cold War, U.S. and Saudi interests diverged. The terrorist attacks of 9/11 further weighed on relations as the U.S. fitfully tried to determine how best to prevent such attacks in the future. The general conclusion was that the authoritarian regimes, by denying basic rights and through poor economic performance, were partly to blame. The Obama administration offered tacit support to the Arab Spring movement, although it can be argued that the results have been disappointing. Finally, the recent decision by the Obama administration not to bomb Syria, even though chemical weapons were used, infuriated the Saudis as it is becoming clear the U.S. will not intervene militarily in the country, thus ensuring that the civil conflict will continue. Essentially, the U.S. is signaling that it is not willing to engage militarily in the region unless the upheaval reaches levels that threaten global stability.

A recent *New York Times* report[1] suggests the Obama administration has decided that the Mideast is not going to derail other important administration goals like the pivot to Asia. Although the article offered little more than broad sketches of future policy, one can easily surmise where the administration is going. Essentially, the U.S. will likely create a balance of power in the region between the Sunni and Shiite states. This will mean normalization with Iran and a recovery in Iranian oil production. With non-OPEC production rising (mostly North American), the Saudis will either have to cut output or suffer falling prices. Given the high cost of maintaining incomes for

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[1] "Rice Offers a More Modest Strategy for Mideast," 10/26/2013, *New York Times*.

Saudi subjects, analysts estimate the kingdom cannot tolerate oil prices under $88 per barrel. This means that the Saudis will be forced to cut production to accommodate new supplies coming from its greatest regional threat, Iran.

Perhaps the most difficult circumstance for Saudi leadership is that there isn't much they can do about U.S. policy changes. The Saudis still need U.S. support, but rising North American oil production means that the kingdom's importance to America is declining. At the same time, there really isn't an alternative to U.S. military protection. The most likely candidate for replacing the U.S. is China, and it may be a generation before it will have the naval power to offer much protection to Saudi Arabia. In addition, there is no guarantee that China wouldn't adopt a balance of power structure that will likely become America's stance in the region.

Ramifications

Any discussion of Saudi Arabia eventually comes down to oil prices and supply. The OPEC cartel, in general, and the Saudis, in particular, are facing a serious supply threat from the U.S. as shale oil supplies rise. Given that these are high cost supplies, there is an incentive for the Saudis to flood the market with oil as they did in 1986 and in 1998 (when the Saudis forced Venezuela into output compliance). The goal would be to send prices dramatically lower; this would undermine investment in the North American oil sector and retake OPEC market share. However, unlike these earlier periods, the kingdom may not be able to execute this program successfully. First, it isn't clear if the productive capacity in Saudi Arabia exists.[2] Saudi Arabia has developed new oil fields but there are worries that existing giants are seeing falling output and may not be able to boost production. Second, without U.S. protection, Iran may react against a production expansion by fostering unrest in eastern Saudi Arabia where Shiites are dominant and the oil fields exist.

As noted above, to thwart the Arab Spring, the kingdom has dramatically boosted spending to support its citizens' incomes. A high level of revenue is required and since oil demand is price inelastic in the short run, a large increase in supply will almost certainly lead to a drop in revenue. Saudi Arabia may not be able to prevent civil unrest if oil prices plummet. At the same time, it will be very difficult for Saudi Arabia to cede market share to Iran if relations with the U.S. normalize. We may be moving into a situation of rising oil price volatility.

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[2] Simmons, Matt, "Twilight in the Desert," John Wiley & Sons, 2005.