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## A View of the Middle East from the Gulf

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November 7, 2017

*This note presents observations from a visit to Abu Dhabi and Dubai, and reflects conversations with a range of investors, business leaders, and advisors working in the Gulf.*

### Key takeaway

**A common theme heard these days is watching and waiting.** The Gulf region's economy has bottomed out as oil prices have recovered from their 2016 lows, but the outlook for the medium term is subdued. This comes against a backdrop of great geopolitical flux—concerning energy markets, the Saudi domestic agenda, Yemen, Iran, and Qatar. As one Western business leader in Abu Dhabi put it, “We don't know what's going on.” The high profile arrests announced in Saudi Arabia on November 5 reinforce a sense of change and uncertainty.

### Regional developments

Cranes are everywhere in Abu Dhabi and Dubai—constructing new residential areas, islands of commerce, a museum, and an amusement park. Shopping centers are full of people promenading, but growth in the retail and consumer sector, a key to economic diversification, has been lackluster. Ample supplies in energy markets, fiscal austerity, low levels of private sector investment, a huge expat exodus, and a downturn in regional air travel have **taken the spring out of the Emirates' economy.** The IMF projects the UAE will see 1.3% growth for 2017, down from 3.0% in 2016.

**All eyes are on Saudi Arabia** as it undertakes a massive economic transformation. Weak oil prices are the immediate driver of change, but prices have been down before. What's different this time is that market experts are talking about reaching peak oil demand in the not-too-distant future, thanks to the rise of new generation vehicles. At the same time, Iran is rising as a formidable regional economic as well as geopolitical power. And, Saudi Arabia now has an ambitious, change-oriented leader: Crown Prince Mohammed bin Salman (MBS) has outlined a policy agenda known as Vision 2030 that draws insights from the UAE's successes in diversification.

**Preparations for selling a small stake in Aramco are proceeding,** but it appears more likely that the deal will be executed as a private or local placement rather than a public offering in London or New York as originally indicated. Untangling and making the necessary declarations about the national oil company's vast enterprise, its financial health, and oil reserves may not be possible logistically or politically at this time. And, the leadership could lose face with a less-than-blockbuster public valuation. This predicament is indicative of the government's larger challenge: It needs foreign cash and investment to fuel its reforms, but this requires more transparency and better governance. Yet, the Saudi leadership has displayed more authoritarian and capricious behavior that could undermine investor confidence.

**The lifting of the ban on women driving is a significant milestone.** It has been touted as a civil rights measure as well as an economic booster: Women will now be able to more easily join the workforce and the money spent on expensive drivers can be diverted to other purposes. But just as important, it's a tactical move by MBS to put the powerful and conservative religious establishment on the back foot while he consolidates power. ►

Key data points (2016-2017)	Saudi Arabia	UAE	Iran
Population, total	32 million	9 million	80 million
Population, 0–14 years of age	26%	14%	24%
Male youth unemployment	22%	9%	23%
Real GDP growth (IMF projection, 2017)	0.1%	1.3%	3.5%
FDI inflows (2016)	\$7.5 billion	\$9 billion	\$3.4 billion
Gross national income per capita (PPP)	\$55,760	\$72,850	\$17,340 (2014)
Governance rankings (percentiles: 1=best, 100=worst)			
Gender gap	98	86	97
Ease of doing business	48	11	65
Corruption perceptions	35	14	74
Innovation environment	43	28	59

Sources: IMF, World Bank, UNCTAD, World Economic Forum, Transparency International, Cornell University.

International media and advisors are focused on the large scale of the business opportunity in Saudi Arabia—even if only some of the government’s goals are met. On October 24, for example, MBS announced that the government would invest one half trillion dollars on a “new generation city” on the Red Sea coast. On the other hand, **regional investors are taking a wait-and-see stance** and looking to park their money elsewhere for the medium term. (London is seen as a solid long-term bet, despite the cloud of a hard or crash-out Brexit.) They are used to insider status and more familial ways of investing and doing business, while the government is pushing the notion of greater transparency, creating a more formal regulatory environment, and combating corruption.

The stunning announcement in Riyadh of a new anti-corruption committee, the arrest of Prince Alwaleed bin Talal and dozens of other prominent elites, and the resignation of Prime Minister Saad Hariri of Lebanon highlights the fast-paced, wide-ranging, and high-stakes nature of MBS’s push to transform the Saudi landscape. The crown prince is taking a tool from the kits of Xi Jinping and Vladimir Putin: Fighting alleged corruption is his new hammer to realign economic interests and consolidate political control. While official graft is a problem, Saudi rule has been based on close political/family/business arrangements and state largesse allocated by consensus-based decision making. Rather than liberalizing this closed system, MBS likely is reordering it according to the interests of his clique, seeking to curtail excessive access to the kingdom’s resources, and reclaim assets to plug the budget deficit. Indeed, the **November 5 arrests were a highly authoritarian move, even in the Saudi context, and have sent a shockwave through the region.** The message MBS is sending is that he can choose who he wants to prosecute and no elite or business is untouchable. This generates significant political risks for foreign partners. (In Brazil, by contrast, independent prosecutors are leading corruption investigations and generally following due process.)

MBS is a bit reminiscent of MSG. Mohammad bin Salman is seeking to use the power of the state to fundamentally reorder politics, economics, and society. He is also leading the charge on behalf of a younger generation impatient with the status quo. A young, smart, and charismatic Mikhail Sergeevich Gorbachev tried doing it all too. But, like renovating an old house, such multi-faceted governance transitions can expose structural failures and take twice as long and cost much more than expected. Can MBS outrun the forces that he is challenging? Right now, he has the initiative and many see stagnation as the only alternative. **A key signpost to watch is whether his campaign drives a deep split in the Saudi royal family. ►**



## Geopolitical context

**All this change comes against a much more fluid geopolitical context.** US-Saudi and US-Israeli ties have markedly improved in the Trump era as each country seeks to curb Iran's influence. Meanwhile, European powers are distracted with Brexit and the future of Europe. Russia's relevance in the region has increased sharply with its intervention in Syria, its friendship with a rising Iran, and its energy politics. In mid-October the Saudi king made a high-profile visit to Moscow in search of new avenues of cooperation—in defense, technology, and energy—and to balance against Tehran's influence and demonstrate autonomy from Washington. Yet, the Kremlin is happy to play all sides to its advantage. Looking at their recent record, Riyadh and Abu Dhabi have not managed their geopolitical challenges very well.

**The civil war in Yemen was succinctly described as a “disaster”** by one executive in Abu Dhabi—a reference to human rights atrocities and the heavy loss of life, crippling damage from Saudi-led aerial bombardments, a raging cholera epidemic, and criticism from the international community. Saudi Arabia and the UAE are looking to contain their costs but they have bought the Yemen problem for the long term (with indirect backing from Washington), because the country is seen as too important to cede to Iran's sphere of influence. Yemen is looking like their Afghanistan, albeit in their back yard.

**The Qatar blockade looms in the background but you can't really talk about it.** Riyadh and Abu Dhabi want to rein in Doha for its willingness to work with new forces in the region such as the Muslim Brotherhood in Egypt and Islamists in Syria and Libya and its projection of influence via al Jazeera. (The message from the Hariri resignation is: Follow Riyadh's line on Iran or you are out.) The conflict is tribal in nature and Doha has been pushed out of the tent. The longer the standoff drags on, the more likely it will persist, as each side digs in and rallies allies. For either side, concession would amount to a tremendous loss of face. But it's also unlikely to get notably worse—whereby Doha cuts off critical supplies of natural gas to the UAE, for example. But the conflict has crippled the Gulf Cooperation Council and its aspirations for regional economic integration. (To get from Dubai to Doha, one must now fly through Muscat.) Meanwhile, Doha is spending down its reserves as it tries to keep its economy afloat.

On the other side of the Gulf, **European firms are working hard to get into the Iran market but they face three challenges.** First, they must not run afoul of American sanctions. Second, they must confront heavy government intervention in the economy, a regulatory environment in need of updating, corruption, a lack of transparency, and complex import tariffs. “Understanding who we are dealing with” is critical, said one London-based insurance broker. Avoiding unsavory entanglements with the Islamic Revolutionary Guard Corps, which is enmeshed in many parts of the economy, is a challenge. These factors make entering the market much slower and more complex than initially expected. Finally, Russian, Indian, and Chinese firms are already active in Iran and seeking the same opportunities without the same governance worries. Beijing is keen to knit Iran into its Belt and Road infrastructure project, while Moscow seeks greater leverage over global supplies of natural gas. For both countries, Iran is a much bigger prize than Saudi Arabia, noted a regional energy expert.

All of this raises a long-term question, suggested a Western business leader based in Abu Dhabi: **Are Saudi Arabia and its Gulf allies on the wrong side of history** or can they move fast, make the right decisions, and remain relevant? ■