



Conflict points and moving parts: Middle East update

While there has been much focus on North Korea as the biggest source of geopolitical risk this year, the Middle East has seen tremendous flux in recent months. This presents a challenge as great as, if not larger than, North Korea for the region's political risk practitioners and investors, alongside the global economy at large.

Middle Eastern turbulence brings several stories into focus. First there are developments playing out in Syria, bringing regional and global powers into potential conflict. Second, Saudi Arabia is undergoing remarkable political and economic change, perhaps linked therein to a third factor – the continuing battle for regional supremacy between Saudi Arabia and Iran, with proxy conflicts playing out in Bahrain, Yemen, Qatar and Lebanon. We can add to this the long-running struggle between Israel and its neighbours; the Kurdish problem in Turkey, Iraq, Syria and Iran, plus fall out from mixed outcomes from the Arab spring in Egypt, Libya and Tunisia; US disengagement from the region and Russia looking to fill the vacuum.

Market Insight



Tim Ash

Emerging Markets
Senior Sovereign Strategist
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What is clear is that the Middle East is a region with many moving parts and potential conflict points.

Global impact

Unlike North Korea, the Middle East is pivotal to the global economy, given its importance to energy supplies, as well as in terms of the global fight against terrorism and in shaping refugee flows to Europe and elsewhere. The region is also now an important part of international capital markets.

With the decline in oil prices, countries in the region have become regular and often large-sized issuers on international capital markets (Saudi Arabia broke the record for the largest global sovereign dollar deal). Indeed, so much so that in 2017 as much as one quarter of sovereign external debt issuance will have originated in the Middle East.

The rise of the radical crown prince

In understanding risks and trends in the region, Saudi Arabia provides a good place to start, and the topic of the moment is the truly meteoric rise of Crown Prince Mohammed bin-Salman (MBS, as he has come to be known) to become heir apparent to aged King Salman.

What we appear to be seeing is nothing short of a revolution in the way the Kingdom is being governed. MBS' rise reflects a fundamental change in the model of succession from brothers, to down the line of sons. Given MBS' youth – 32 years – and assuming he does in fact inherit the crown from his father – this suggests a leader who is likely to be in power for decades to come and with the potential to have a lasting impact on both Saudi Arabia and the broader region.

On the plus side, MBS is offering more decisive government and a focus on addressing key underlying structural weaknesses in the country. This includes reform of the economy, the influence of religion over the nation, and also social factors with a focus on the role of women in society. MBS offers a blueprint of reform in his 'Vision 2030', and the model appears to be shaping Saudi Arabia in the mould of the UAE, and Abu Dhabi in particular, with an absolute monarchy, but rationalised around a smaller group of royals.

Saudi Arabia has the balance sheet for this vision to be realised (US\$490 billion in FX reserves, a low debt ratio and state-owned assets to sell). And I think that many would argue that these reforms are long overdue. But the revolutionary nature of the change suggests that risks are likely to come from vested interests (royal princes moved aside and the old religious establishment conservative to more radical change). MBS' own relative lack of experience also raises question marks for some as to how he will manage the delicate nature of palace politics, alongside challenging foreign affairs.

Home reform & allied alliances

Creating a strong domestic economy is one part of the longer-term strategy of MBS and Saudi Arabia in confronting what it would likely describe as the number-one geopolitical threat: the rise of Shia Iran and the battle for religious and geographic

supremacy in the region. Indeed, from Riyadh, the emerging Shia crescent forming across the region, with Iranian influence building in Oman, Qatar, Iraq, Bahrain, Yemen, Syria and Lebanon seems to be a growing concern. Saudi Arabian efforts to confront this in Bahrain, Yemen and most recently in Qatar and Lebanon, suggests that the Iran / Saudi Arabian schism will be an increasing pressure point to monitor over the months and years to come.

Saudi Arabia's strategy seems to be one of asking traditional allies, in countries such as Lebanon, Qatar and Oman, to choose their sides – but for many this entails reversing a period of 'out-reach' to Iran, encouraged by the Western-Iran nuclear deal, promoted by the former Obama administration. This is perhaps the way to view Saudi Arabia's apparent withdrawal of support for its proxies (Hariri) in Lebanon, as a call for political leaders in Lebanon (and elsewhere) to push back against Hezbollah, but also for the US and Israel to step up their own activities to counter the threat from Iran.

In the case of Lebanon, it seems unlikely that Lebanese political leaders themselves have the power to rise to this challenge. This raises the question as to whether Israel, as the predominant regional power, and the US, still the hegemon global power, have the appetite to adopt a more confrontational approach towards Iran so as to ease Saudi concerns, or whether Saudi Arabia will feel the need to take a more direct approach.

In the case of Israel it has bitter memories of its last largely failed military intervention in Lebanon in 2006, and might still be loathed to risk a full-scale military conflict. Instead it might continue with frequent targeted military strikes against Iranian/Hezbollah assets in Lebanon, Syria, Iraq and even Iran, while also perhaps looking to the US to take a fresh look at the Iran sanctions regime, which might even extend to rolling out sanctions against Lebanese banks with links to Hezbollah – which already seems to be the direction of travel for the Trump administration.

Closing thoughts

We have a toxic, unstable mix emerging in the Middle East, with the Saudi-Iran schism building momentum, and an inexperienced (in foreign affairs) Saudi administration feeling increasingly threatened and encircled by Iran, but willing to take a more interventionist/confrontational approach. This might be partly aimed at buoying nationalist support at home to smooth the political ascent of MBS. Israel also likely feels uncomfortable with the growing strength of Iran and Hezbollah against its borders, especially coming out of Lebanon. The risks of Israeli military intervention are not insignificant – but any direct Israeli intervention in Lebanon, if it happens, is likely to be large scale and inevitably supported by the US. All this comes as US leadership in the region is in a state of flux, with mixed messages being sent, e.g. over the crisis in Qatar, with different parts of the US administration backing Doha and others giving impetus to Riyadh to take a greater leadership role in the region. The lack of US leadership in the region might well reflect the legacy of huge policy misstep in the recent past, including in Iraq, Libya and Syria. It might also reflect rising US domestic oil production, which has made the US, not Saudi, the swing global oil producer, but less dependent on the Gulf.

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