SAUDI ARABIA AND THE POLITICS OF OIL

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Saudi Arabia and the Politics of Oil

By George Friedman and John Mauldin

> *This report delves into the geopolitical and economic consequences of the events in motion in Saudi Arabia. Just ahead, George and John ponder the impact of oil prices on the government, and not only war-game possible outcomes in Saudi Arabia with sub-$20 oil, but also consider a scenario where problems in Saudi Arabia create a disruption in oil supply that forces the price of crude to new all-time highs.*
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> *To say that Saudi Arabia is on the verge of its most significant change in decades is not an exaggeration. It has the potential to reshape not only the Middle East but the entire world. The importance of developments in Saudi Arabia requires that investors have an in-depth background on the current situation and possible consequences. This report is presented in two parts: The first section discusses the background and information needed to understand the second section.*

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On Jan. 4, Deputy Crown Prince Mohammed bin Salman revealed, in an interview with the Economist, that Saudi Arabia was considering an initial public offering (IPO) for state-owned oil firm Aramco. Chairman of Aramco Khalid al-Falih clarified, in an interview on Jan. 27 with Al-Arabiya, that the IPO would not include Saudi Arabia's oil reserves, estimated at 268 billion barrels.

"The reserves will remain sovereign," al-Falih said. He added that the kingdom is mulling options for an IPO of the firm's "ability to convert these reserves into a financial gain."

The speculation is that he refers to refineries, possibly pipelines and other auxiliary equipment. This makes more sense than selling a share of their oil holdings while prices sit at multi-decade lows.

The Saudis' actual plan for Aramco, and how they will proceed with the IPO, remains unclear. Prince Mohammed's statements were vague, and al-Falih made it clear that the oil reserves belong to the state. Since the Saudis nationalized Aramco fully in 1980, its internal finances have been opaque. The company is reluctant to release such information because its financial success is so pivotal to Saudi Arabia's ability to maintain social stability in the kingdom and develop a strong military. Its balance sheets are nothing less than highly sensitive state secrets.

Whether or not the IPO happens is not important. What is vitally important is that it was publicly discussed by the Crown Prince of Saudi Arabia. He was fully aware of the consternation the statement would elicit from within the kingdom and across the world. He knows there could be political repercussions. Yet he said it.

We can deduce two things from this new "openness." One is that the direction of financial developments in Saudi Arabia have forced it to contemplate radical steps, and the Crown Prince judged it necessary to alert the public of the possibility. The second is that the steps that must be taken could threaten the survival of the regime.

The Significance of Aramco

There are two key reasons Aramco is so important to Saudi Arabia. First, Aramco is the world's most valuable company (with an estimated worth of several trillion dollars). Oil revenues constitute 90% of the government's revenue and 40% of its GDP.

Second, Aramco is the country's source of geopolitical power. Saudi Arabia—and Aramco by extension—holds the world's second largest proven crude oil reserves. Oil is what transformed Saudi Arabia from a desert containing bands of religiously orthodox tribal Arab chieftains into one of the Middle East's strongest powers. Since the Saudi government nationalized Aramco, the company has become the crown jewel of the kingdom and the key driver behind Saudi Arabia's technological, military, and economic expansion.

Aramco is also a symbol of the triumph of the Saudi royal family. Saudi Arabia emerged out of the Ottoman Empire, dominated first by the British and later by the Americans. One by-product of that domination was the formation of the Arabian-American Oil Company—Aramco. In the years that followed the 1973 Arab oil embargo Saudi Arabia enjoyed unprecedented prosperity. By 1980, Aramco was nationalized, and in 1988 it was renamed Saudi Arabian Oil Co., or Saudi Aramco. This demonstrated that the royal family cared about the sovereignty of the Arabian Peninsula and intended to control its own destiny.

Among Islamists, the nationalization meant that the holy cities—Mecca and Medina—were in the hands of the faithful, and not the puppets of foreigners. For the royal family, it meant control of Saudi Arabia's wealth was in their hands. For others, the prosperity of the post-1973 period would in due course trickle down to them. It was a defining event that further solidified Saudi control. The reality may have been more complex, but the emotion was genuine and powerful.

It was assumed that Saudi control of the oil was a permanent change. Prior downturns in the oil market had been managed without questioning this core element of the regime. In the 1980s, the Saudis dealt with low oil prices by borrowing, but the world was very different back then. The Saudis enjoyed stability at home and the region was far less chaotic than it is now.

This latest price plunge has come at a time of major transformation for the Saudis at home while the Middle East is in the throes of multiple crises, many of them at Saudi Arabia's borders. Meanwhile, they are caught between the need to maintain market share in the global oil trade and the damaging effects of low oil prices. To manage such unprecedented challenges, the new generation of Saudi royals are trying to slash the budget, find new income, and embark on a difficult privatization initiative.

These economic issues are compounded by the political imperatives of two young royals—Deputy Crown Prince Mohammed bin Salman and Crown Prince Mohammed bin Naif. They are essentially running the country, given that King Salman is too ill to govern. To change the way Aramco, the lifeline of the country, has been managed for decades will be difficult. Yet in spite of the hurdles they chose to raise the possibility.

Facing Critical Economic and Political Challenges

The combination of low oil prices and regional instability directly threaten Saudi Arabia's survival and created a financial situation that is untenable for the Saudi regime. Saudi Arabia is not in dire straits at the moment, with sufficient reserves to sustain the country for a few years. However, if these reserves do run out, it will be in hazardously deep trouble.

There is one key principle driving Saudi Arabia to sell shares in Aramco: the kingdom needs money. And it's more than Aramco's operations can provide in the current context of long-term low oil prices. The kingdom needs money to buy time.

The Saudi Arabia Monetary Authority (SAMA) acknowledges that the country ran a deficit of 21.6% of GDP in 2015, a quantum leap from 3% the prior year. They hope to cut that to 13% in 2016. However, the IMF expects a deficit of 20% in 2016. They have burned through almost $100 billion in reserves the last few years. A second, similarly-sized deficit would consume another $100 billion. Reserves now stand at roughly $650 billion.

The problem with those estimates is that they assume an average price for Saudi light crude of $50 in 2016. As we write this report, West Texas Intermediate (WTI) is priced around $30. And that is the *delivered* price of oil. The actual price a producer gets is even less.

In the past, OPEC, led by Saudi Arabia, would reduce production in order to maintain the oil price. Today, there are four problems with that process.

First, oil above $60 or $70 would mean that US production would continue to increase, and the US is already the world's #1 producer. OPEC would have no choice but to keep cutting further in order to maintain that price.

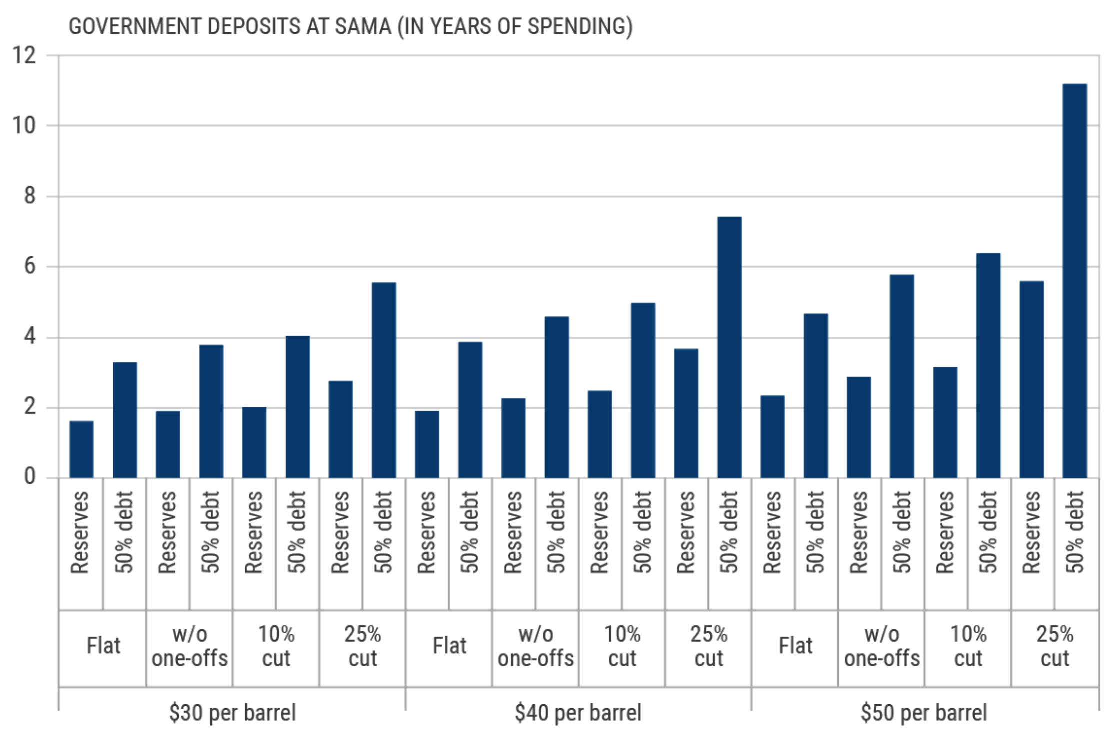
Second, OPEC members (other than Saudi Arabia) almost always cheat on their production quotas when they can. Considering that other OPEC nations are desperate for income, the incentive to cheat is all powerful.

Third, the US-Iran nuclear deal and subsequent lifting of sanctions means that an additional 1 million barrels per day will soon hit the market. As international oil companies vie for the privilege of drilling more oil in Iran, it will put further upward pressure on supply.

Fourth, although drilling rig usage in the US is down by nearly 75%, production has just now begun to fall off. It will take some time before enough US production comes off the market to put upward pressure on prices.

So, what happens to Saudi Arabia's budget deficit if oil stays in the $30 rather than $50 range? Bank of America Merrill Lynch gives us the following estimates:

SAUDI RESERVES SENSITVITY

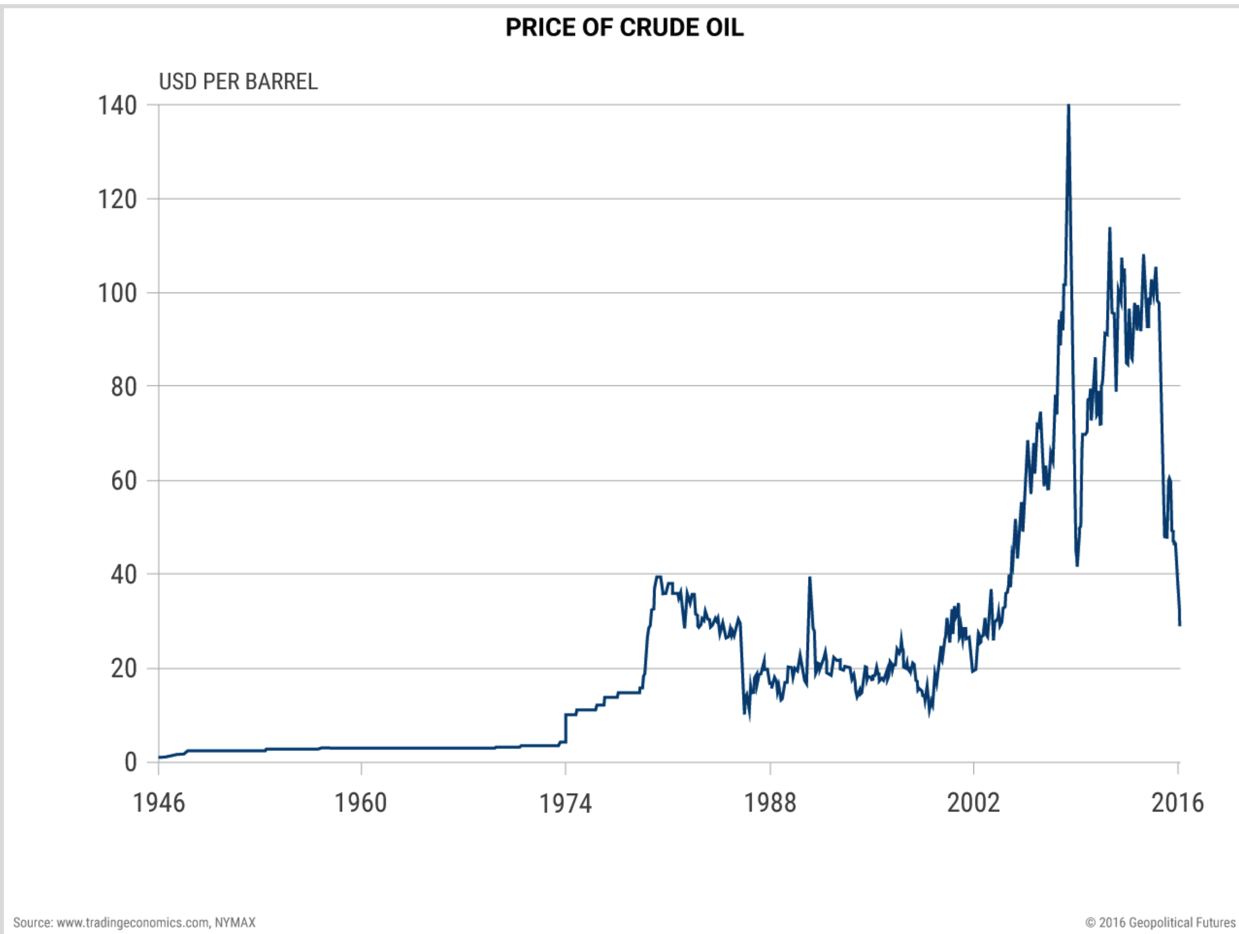


Note: Flat spending means flat vs 2014/2015 levels, and the other assumptions represent spending without the one-off Royal Handouts (4% of GDP), or spending cuts of 10% and 25% of total. The latter would include phasing out of the Royal Handouts and a 50% cut to on-budget capital expenditures versus the historically elevated capital expenditure levels of 2014. Additionally, the financing side matters, whether spending is financed in totality through government deposits at SAMA or 50% financed by domestic debt issuance.

Source: Haver, BofA ML Global Research

Even with a 25% budget cut, Saudi Arabia would have just 3 to 5 years of reserves and borrowing available at $30 oil. We note that several respected investment banks are projecting that oil will fall to $20 this year. If a crisis in Europe or China were to even slightly reduce global demand, $20 oil seems a very real possibility.

A global recession? That would add a perfect storm potential to push oil prices down to levels not seen since the 1970s. Now, we are not predicting this will happen. We're saying that wise investors must recognize the not insubstantial tail risk of such an event and have their contingency plans already developed.



Bottom line? It is highly conceivable that Saudi Arabia could face immense budgetary pressure before 2020. That was unimaginable just 3 years ago.

External Challenges: Why Saudi Arabia Needs Money for Foreign Policy

The Saudis have been spending lots of money to keep the Arab world—itself in a state of crisis—intact. Many Arab states have either collapsed or been severely weakened. Saudi Arabia now confronts at least two key external challenges: Iran and the Islamic State.

Saudi Arabia sees itself as an enemy of Iran. As neither side is powerful enough to wage war on the other, they instead wage various (and very expensive) proxy conflicts throughout the region. When protests began in 2011 against the Iranian-backed regime of Bashar al-Assad in Syria, Saudi Arabia saw an opportunity to deal a crippling blow to Iranian power in the region. The Saudis used their oil wealth to back rebel groups, most of which are to varying degrees jihadist, in order to attack the Assad regime.

In Bahrain, the Saudis intervened when protests by the Shiite majority population, also backed by Iran, threatened to overthrow the pro-Saudi Sunni monarchy. The Saudis are also involved in a military conflict in Yemen, where Iran is backing Houthi rebels. Meanwhile, in Lebanon the Iranians seem to have the upper hand.

Beyond fighting proxy wars, Saudi Arabia also supports Arab states in economic turmoil, including Bahrain, Jordan, Morocco, and Egypt. They are attempting to lead a Sunni Arab coalition against Iran—and using their wealth to cement those relationships.

The second key challenge is the rise of jihadist actors, which Saudi strategy played a direct role in creating, particularly through its involvement in Syria (not to mention its sponsoring of religious schools throughout the Muslim world which teach a very severe form of Islam). The most significant of these groups is the Islamic State (IS). At this point, IS is behaving much like a state and has declared a caliphate in large parts of Syria and Iraq.

The Islamic State's ideology is a direct challenge to Saudi Arabia. IS is competing with the Saudis for leadership of the Arab and Muslim worlds. The Saudis possess more advanced technology than IS, but they have a limited numbers of troops with little fighting experience that they can deploy.

Meanwhile, IS has proved to be both a skilled and resilient force in Syria and Iraq. Saudi Arabia, therefore, is committing large amounts of monetary support to rebels in Syria fighting IS because it fears they could attack the kingdom. Already, IS has been staging attacks on Shiite mosques in Saudi Arabia and leveraging the region's polarized sectarian climate to undermine the kingdom's security.

The kingdom is caught in a catch-22. On one hand, the Saudis wish to topple the Assad regime to weaken the Iranians, while on the other they fear empowering IS. In fact, the Saudi strategy has a conundrum hardwired into it. The more the kingdom fights Iran and its Shiite allies, the more it ends up facilitating the IS agenda.

Internal Challenges: Saudi Arabia's House of Cards

Saudi Arabia also faces serious internal challenges, which are arguably more pressing. The foundation of the country's social system is the state's ability to maintain a safety net for various segments of Saudi society. Seventy percent of Saudi Arabia's population is under the age of 30. The government provides large subsidies for commodities like food and oil and offers social services and education for its majority Sunni Arab population.

The Saudi government currently provides free healthcare, free education, subsidized water and electricity, no income tax, paid-for public pensions, and nearly 90% of Saudis are employed by the government, often at higher wages than the private sector offers. Less than 20% of unemployed Saudis want a job in the private sector. That is seen as something for expatriate workers.

There is evidence that suggests significant cuts to the expenses and allowances to the Saudi royal family have been made. Cuts in other parts of the government and employment are ongoing. There is speculation that the government is looking at imposing a sales tax or income tax. Just about the only place the Saudi government is not cutting is the defense budget.

Saudi Arabia also has a significant Shiite minority—possibly 20% of the total population—which is clustered in the east near key Saudi oil fields and in the southwest near the Yemeni border. Riyadh has to somehow manage this group, so that Tehran cannot overly influence it.

Saudi Arabia's current financial straits render it unable to dramatically increase the money it throws at problematic groups in the country like dissident, reformist Shiites and jihadists. State-sponsored domestic spending that keeps the kingdom cohesive has also been curtailed.

The Saudis also face a significant leadership crisis. The current monarch is the ailing 80-year-old King Salman, son of King Abdullah bin Abdulaziz, who died in January 2015. The former king did decree a succession law before his death, but no real succession system is in place.

The decree has been over-ridden by the informal line of succession and the practice of appointing a deputy crown prince and a second deputy prime minister. Consequently, the current king elevated his 30-year-old son, Prince Mohammed, to the position of deputy crown prince and gave him sweeping powers—a move met with apprehension within the royal family. He has been making very controversial moves, and parts of the family think he is not the most qualified of his generation.

The kingdom is built on oil money, and that money was used to create a technologically advanced and powerful country. But the plummet in oil prices with no sign of a quick recovery, a brewing crisis of succession, the potential for domestic unrest due to budget cutbacks, and unprecedented external challenges have pushed Saudi Arabia in a hazardous direction: the consideration of an IPO for their most valuable asset, Aramco.

Wild Card Financial Woes

There are indications that investors are trading away their riyals and taking their money out of the kingdom's banks. Figures from a report released by the Riyadh-based Jadwa Investments show that, in December 2015 alone, account holders converted 80 billion riyals ($21 billion) into foreign currency. The report suggests that these worried investors are probably taking their money out of the country. This comes at a time when the Saudis are under great pressure to devalue the riyal.

Figures from Jadwa also show that total bank deposits have been contracting by slightly over 1% month-on-month, which would suggest that the outflow of money underscores a deeper uncertainty about the Saudi financial system. For comparison, such an outflow is not that far percentage-wise from the outflow Greek banks suffered at the beginning of their crisis.

A devaluation on par with the currencies of nations in their region would mean a 40-to-50% drop in the currency. Given the kingdom's significant reliance on imports, an event like this would be highly inflationary and have a critical impact on subsidies.

The Saudis have responded by stating they have no intention of de-pegging the riyal from the US dollar. (Just as every central bank in the world maintains right up until the moment of actual devaluation. What else can they say?) This investor anxiety is unlikely to be the result of low oil prices given that the kingdom has one of the lowest breakeven prices for oil production and is relatively (versus Russia or Venezuela) well-cushioned to withstand low oil prices.

Why Oil Prices Have Plummeted

Despite the significant impact of low oil prices on the kingdom's economy, the Saudis themselves are in part responsible for the decline in crude. The kingdom exports over 10 million barrels a day. Riyadh has refused to cut production to counter the emergence of shale oil in North America. Additionally, it has sought to take the sting out of Iran's international comeback in the wake of sanctions relief. Aramco's chairman made it clear at the World Economic Forum in January that his company was not about to cut output and give up its market share to reverse the price fall.

At a meeting on Nov. 27, 2014, the Saudi-dominated oil cartel OPEC decided against cutting production and left member states to continue to freely produce. Several years ago, OPEC moved away from individual quotas to an aggregate output cap. At another meeting six weeks ago, OPEC nations still could not reach an agreement on cutting production despite the sharp plunge in oil prices.

The Saudis and their Gulf allies contend that they would only cut output if others, including both members of OPEC and non-OPEC members like Russia, did the same. However, Moscow pumped 10.9 million barrels per day in January 2015, slightly ahead of Riyadh's 10.1 million.

On Feb. 16, talks between Saudi Oil Minister Ali Al-Naimi and Russian Energy Minister Alexander Novak yielded an agreement to freeze production at January levels, and OPEC members Qatar, Kuwait, and Venezuela all agreed to join in. This handshake deal, however, is relatively meaningless.

The deal is reported to include a caveat that Iraq and Iran participate. But cash-strapped Iraq is pumping oil at record rates because it desperately needs money, and Iran has repeatedly insisted it will increase output now that sanctions against it have been lifted. The only way a potential deal like this works is if every oil producer agrees to freeze or cut production—and the odds of such consensus is virtually nil.

In addition, there is simply a surplus capacity of oil on the market. It is near-impossible to raise the price of oil with cutbacks, much less with a production freeze. Global oil supply exceeds demand by approximately 2 million barrels a day. And this is before Iran production truly comes online. This drives the oil price down further and forces the Saudis to tap their foreign reserves.

Aramco's chairman has argued that while in the past his country had acted as the "reserve bank" in the oil market, it never accepted the sole responsibility for finding a solution to the oil glut and waning demand. He has also said that the kingdom can withstand the impact of low oil prices for some time. Clearly, Riyadh is banking on its reserves and the option to cut production when it is absolutely necessary.

However, floating the idea of an IPO and the overall challenges the Saudis face indicate that Riyadh is not in as comfortable a position as it would have the world believe. The other major challenge behind selling shares in Aramco will be for Saudi Arabia to complete the sale without the inner workings of the kingdom's most important state organ becoming public knowledge.

A potential IPO signals that Saudi Arabia realizes the old ways of doing business are not going to be enough. That means the royal family is struggling to find ways to raise cash and not lose control over the oil sector. But full control over Aramco has allowed the Saudis to conceal from their own public (and the world) how much money is siphoned off to the ever-growing royal family before proceeds make it to the coffers of the Finance Ministry.

Regional Consequences

Nowhere is the low price of oil and Saudi Arabia's overall behavior more evident than in OPEC. Since it was founded in 1960, OPEC has been a useful tool for the Saudis to control the price and supply of oil. The 1973 oil crisis further boosted the Saudis' confidence that they could affect oil prices, given the operating assumption that demand for crude was on a long-term upward trend due to the growth of economies around the world.

However, the rise of Russia as a major exporter, the growth in US shale energy, and the decline in global demand following the 2008 financial crisis have converged to alter how the Saudis manage oil supplies and prices. The net effect is that OPEC as a cartel has become virtually defunct.

Indeed, only a few weeks ago Saudi Oil Minister Ali al-Naimi remarked that OPEC is not a cartel. That statement is true considering that slowing global growth has the major oil exporters focused on maintaining their respective shares of the market.

The $107 recent peak in oil prices was in June 2014, after which prices started to retreat. By November 2014, they had dropped 31%. Then in December 2015, OPEC refused to cut production and the price sank another 60% into the $30 range. The key reason the Saudis refuse to lower production is because such moves in the past meant loss of market share to other OPEC and non-OPEC producers (especially Russia, the US, and Canada).

To a great extent, the American and Russian oil sectors have influenced the Saudi decision to uphold output. Yet Riyadh is much more concerned about countering Iran's upward trajectory. From the start, the Saudis were opposed to lifting sanctions on Iran, because even while under sanctions Iran was able to expand its influence in the Arab world.

Now unencumbered, Iran represents an even bigger threat to Saudi Arabia, especially with the Arab world falling apart. Depressed oil prices would work to weaken Iran and limit its resurgence. Already, this policy has weakened the majority Shiite Iraqi regime, one of Iran's key allies and another major oil exporter. The Iraqi prime minister admitted recently that his government is not able to pay its bills, much less effectively confront the Islamic State, which controls large swathes of his country. This is another example of how Saudi strategy against Iran and the Shia empowers the Islamic State.

Low oil prices also hurt Russia, whose support of the Iranian-backed Assad regime serves as a key obstacle for the kingdom's plans to shrink the Iranian sphere of influence. Russia lacks the level of foreign reserves the Saudis have. So as the Russian economy deteriorates, the Saudis hope Moscow will be forced to scale back support for Syria. Saudi Arabia seems committed to drawing down its foreign reserves in the belief that it can outlast some of its competitors.

The Saudis and their Gulf energy exporting partners (Kuwait, United Arab Emirates, and Qatar) also take comfort that low oil prices help their allies who import oil and whose economies are struggling. These include Egypt, Pakistan, and Jordan. This lessens the pressure on the Saudis to ensure the stability of these countries.

Intentions aside, it will be very difficult for the Saudis to manage an increasingly complex and unraveling situation in the region while belt-tightening at home. The war effort in Yemen, support for rebels in Syria, and the efforts to create an anti-Iran Islamic military alliance are all a major drain on their revenues.

Over the next few years, the Saudis can easily spend another several hundred billion dollars from their reserves on all fronts and not achieve the desired results. In the meantime, the reforms that they are pursuing, in particular the proposed Aramco IPO (to the extent that the Saudis can realize it), are all much longer-term objectives.

Global Implications

Saudi Arabia has been trying to achieve several different goals in terms of oil pricing: sustaining revenues as high as possible, keeping supply sufficient to foster global growth and thus demand for their prized commodity, and control price increases to slow the world's pursuit of alternatives to OPEC oil.

The Saudis are deeply concerned about the rise of substitutes for OPEC oil, especially with the shale revolution in North America. They are particularly worried about the decreasing value of their oil and thus have an imperative to throw off the North American shale industry. And after 15 months of living with low oil prices they are achieving the desired result. Some 45 US fracking firms are already insolvent or have been forced to re-negotiate with their creditors. Riyadh wants to see this list of distressed companies expand in the coming months.

However, this may prove to be a temporary victory, as technological strides continue to drive down the cost of shale oil and have quadrupled output since 2009. At the World Economic Forum in Davos last month, energy expert and IHS Vice Chairman Daniel Yergin said that shale is bound to bounce back once prices return to the $60-a-barrel range. IMF Deputy Director Zhu Min concurs and says that American shale altered the balance of power in the global oil market and OPEC can't do much to change that. The once-powerful cartel can now only set a bottom for prices.

A shale revival is considered inevitable given that investors are waiting for a price rebound to revive bankrupt US shale drillers. The Saudis have wounded US shale, but it is extremely unlikely they will succeed in killing it.

The longer the Saudis stay their current course, the more likely it will push cash-reserve poor countries into crisis. And Russia, which is facing difficult economic conditions at home and a major reversal in Ukraine, tops this list. Its military intervention in Syria was a key part of its Ukraine strategy. The goal was to extract concessions from the US on sanctions in exchange for helping Washington manage the Islamic State. The Kremlin has yet to achieve that goal, and cheap oil has made life much more difficult for Russians. We expect that Russia will be significantly weakened due to falling oil revenues.

The situation is the same for other countries that are part of the Russian sphere of influence. Azerbaijan is another major energy exporter in a financial crunch that has led to public protests and the threat of a major banking crisis. Baku has been forced to support at least 3 banks that have gone bankrupt.

Far worse is the situation in Central Asia where energy exporting nations like Kazakhstan, Uzbekistan, and Turkmenistan are at risk of destabilizing. The regimes in these countries are holdovers from the Soviet era and have managed to survive and maintain control largely due to cash from energy exports. The crises in Russia, China, and the Middle East are bound to adversely affect the Central Asian republics, and depressed energy prices are likely to exacerbate this process.

Conclusion

Saudi Arabia is facing an existential crisis. Its economic foundation is oil and the mechanism for monetizing it is Saudi Aramco. Oil prices have dipped in the past, but this time it is different. This decline has every appearance of being a long-term repricing of oil. A rise in oil prices over the next 4 to 5 years is uncertain at best. As shown above, even at $50 or $60 oil, Saudi Arabia will still run reserve-draining budget deficits without further cuts in spending, which would likely lead to internal unrest.

That means that Saudi Arabia will likely run out of financial reserves by 2020, if not sooner. That will create a massive political crisis from both within and outside the royal family. The guarantor of the Saudi regime is money. The same people who were delighted by the nationalization of Aramco, and who are now shocked at the thought of selling it off piecemeal, will respond to austerity—to put it mildly—with intense disappointment and hostility to the regime. You cannot both foresee a financial calamity and not see a political one.

This will be happening in the only Arab state that frames the Syrian-Iraqi battle zone, and the only regional power that is Arab. The other three regional powers—Turkey, Iran, and Israel—are not likely to be shattered by the kind of financial crisis facing Saudi Araba. That means that as the Arab world in the Middle East fragments, the only native powers are not Arab, and the only global power with an interest will be the US, the former co-owner of the oil company that had to be nationalized.

Facing strategic and financial failure, it is hard to imagine how the Saudi regime in its current form can survive intact. It has enemies who will seize on the decline of the Saudi royal family to stake their own claim. The price of oil might surge temporarily if OPEC agreed to cuts and everyone (surprisingly) implemented them. We see this as a low-probability event with short-lived benefits. As noted above, production from the rest of the world would soon increase with oil in that $50-$60 range.

So, we can understand why the Crown Prince floated the idea of a 5% IPO of Saudi Aramco. In extreme circumstances, the Saudis can extend their viability beyond the 4- to 5-year period by selling parts of this major asset. The problem is if they sell now they will get depressed prices, given the uncomfortable state of the global investment markets. If they sell when they are on the verge of a crisis, they can get even less.

The Saudis can either hope for the best or sell parts of Saudi Aramco. Their alternative is to slash expenditures in the kingdom and generate a potentially massive uprising. The Saudis are aware of their limited options. The Crown Prince went public on the theory that floating the IPO idea now is less likely to destabilize the regime than withholding the idea until it must happen.

This is the shrewdest move but one not likely to succeed. The opposition sees the same figures we do on reserves and prices. In politics as in markets, players look at future possibilities, determine likely outcomes, and act on them now. The crisis in Saudi Arabia has not yet arrived, and many in Saudi Arabia see greater risk in taking premature political action than in waiting.

Even so, over the near term, it is not reasonable to expect opponents of the Saudi regime to wait until the crisis arrives. The regime is strong and can suppress opposition now. But it will weaken, and as it weakens opposition will emerge. The Saudi regime was built on oil and money, and neither is there in the long run to sustain the regime. It is hard to imagine how the financial meltdown Saudi Arabia is facing doesn't trigger political upheaval.

Several generations of global investors have had their worldview shaped by the status quo in Middle East oil politics. But there is no sanctuary from the fallout when disruptive asymmetry collides with established yet unstable systems. We are experiencing just such events today.

As the Saudi regime weakens, the following developments can be expected:

- Decreased ability for Saudi Arabia to control the various social, political, and economic factions within state and society, leading to greater instability in the country;
- Dissent within the Saudi royal family;
- Shiites emboldened in the Eastern province (where most of the oil is) and in the southwestern border regions near Yemen;
- Increase in terrorist attacks on Saudi soil;
- Loosening control over the Saudi religious establishment, which could help boost the legitimacy of groups like Islamic State and al-Qaeda;
- Public agitation from a largely youthful population;
- The decline of Riyadh's ability to shape events in the region, especially by backing proxy groups;
- Many of the groups Saudi Arabia used to support could descend into IS orbit, strengthening the Islamic State's position;

If in the end the Saudi regime falls, you could see the following:

- Civil war in the kingdom, leading to the breakup of the country into multiple statelets and a long battle for control of Saudi oil fields and infrastructure

- An expansion of areas controlled by IS, particularly in Syria and Iraq but also potentially within territory currently controlled by Saudi Arabia;
- Iran's influence in the region, and by extension Russia's influence in the region, would greatly increase in the short term;
- Turkey drawn into the region and facing inevitable conflict with Iran as the two main regional powers left standing;
- The destabilization of countries that border Saudi Arabia, including Jordan, Bahrain, and Kuwait, and the worsening of an already chaotic situation in Yemen – essentially, the Arabian Peninsula on fire;
- Israel facing new potential enemies as a result of the possible destabilization of the situation in the West Bank and in neighboring Jordan and Lebanon;
- And of course uncertainty about this critical region will impact oil, including disruption of oil supplies to key importers of Saudi crude, but also such sectors as transportation, tourism, trade, and defense, to name just a few. Expect global stock markets to gyrate, greater investor insecurity, and periods of extreme volatility.

Do not ignore the possibility of the unexpected. Stay informed and have your contingency plans in place.