

CHAPTER IV
THE IMPACT OF THE CRISIS FOR SAUDI
ARABIA'S POLITICAL STRATEGY

The world economy is experiencing a collapse at this time. This is due to the drop in world oil prices since 2014. In fact, world oil prices fell by 70 percent within one year. (BBC, 2016)

In addition, oil prices once occupied the lowest position in the last 12 years i.e. below 28 US \$ per barrel. Saudi Arabia, which is one of the oil producers in the world have abundant supply than demand of crude oil itself. This also became the cause of world oil prices fell. Oil-producing countries immediately got the impact of the drop in world oil prices, including Saudi Arabia as one of many countries in the Middle East that become a highly considered as important in the international arena, especially because of its oil wealth and their proximity to the United States and the West.

The Saudi government directly increase the debt due to declining state revenues due to Saudi Arabia have been relied on oil as a major revenue to finance the country's development. This situation has forced the government to increase debt through foreign loans.

The previous chapter has already explained about the dynamics of world oil prices that become the source of this crisis. This section answers the research

question on the previous section. The question is answered by providing an analyze of the Saudi Arabia's political strategy towards the declining world oil price in 2014-2015 as the topic.

Saudi Arabia relies heavily on petroleum products as a source of state income. The dependence has occurred since oil sources were discovered on March 3, 1938. (Simmons, 2005) The oil sector accounts for 70% of the country's revenues with oil reserves of 268 billion barrels or the largest in the world. Unfortunately, the glory of oil that has raised the kingdom's economy has recently begun to recede so that they have a massive deficit. Currently, world oil prices are sold at around US \$ 40 per barrel. In fact, in early 2014 the price of oil is still US \$ 100 per barrel. As a result, Saudi Arabia has a budget deficit of US \$ 100 billion in 2015. (Number13, 2016)

As discussed previously, the supply-demand factor is the most fundamental factor in influencing oil prices. Geopolitical factors caused by the political conditions of oil producers (Middle East) leads to the certainty of supply, while the paper oil market only affects short-term basis (short-run). A real consumer from the oil industry or the retail consumer is influencing the real demand of oil.

Supply-demand curve is simply illustrated in the graph below, which explain that the meets of the demand and supply curves will be formed rium, the market price (P^*) and the quantity of goods / services that are transacted (Q^*). See Figure 4.1 below:

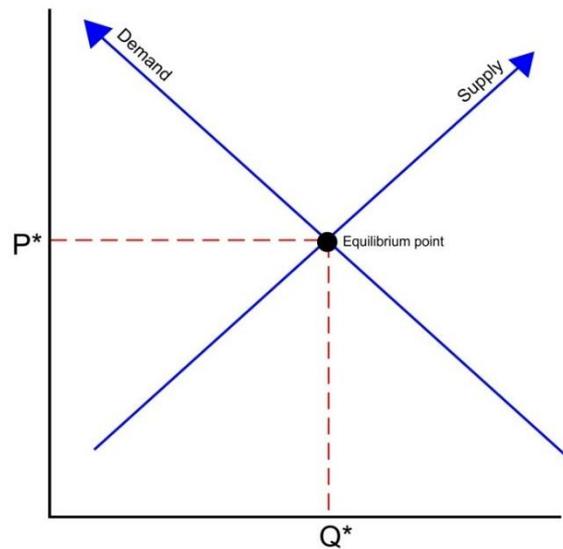


Figure 4.1

Supply-demand curve (Study.com, 2003)

Since 2014, the Saudi Arabia has led OPEC to use the strategy by maintaining market share rather than reducing production to support oil prices in global markets. Saudi Arabia believes crude oil prices can create a balance in the market. This is believed to be able to push up oil prices.

In addition to the deficit problem due to the decline in oil prices, Saudi Arabia was faced with problems such as decent housing needs and large unemployment, and subsidies. Nearly half of the royal population is now under 25 years old and millions of people are looking for work. Looking at what Saudi Arabia is experiencing, it is not impossible that the country will borrow money to a number of banks or international financial institutions. If so, Saudi Arabia must immediately find a way to run its economy after the fall in oil prices.

A. Saudi Arabia's Oil Market Strategy

Although one of the factors of the decline in world oil prices is a lack of demand from oil, Saudi Arabia refused to cut production because they hope other manufacturers such as American oil companies out of OPEC global business.

The issue of oil oversupply has occurred several times in the past and production cuts seem to be the only steps OPEC can take. However, with a third of OPEC's total production controlled by Saudi Arabia, the authority to regulate and maintain oil price stability can only be regulated only by Saudi Arabia. With the Saudi's attitude that seems to let the oil price continue to decline like this and there has been no satisfactory explanation from the country for the steps they take, it is natural for us that we consider this a grand scenario of the Saudi Arabia towards their oil market. Recent geopolitical conditions form the basis of the author's view in this crisis.

The geopolitics and geo-strategy in the case of oil is happens very subtly in Saudi Arabia. The close relation between Saudi Arabia with the Western nations is intended to maintain the legitimacy of the regime in the leadership of the king. The economic problem of Saudi Arabia was initially caused by the explosion of oil prices in the 1970s. This was caused by the Arab dependency on high oil industrial sector. Furthermore, this dynamics of oil prices was a major factor in state revenue fluctuations, and greatly affected the country's fiscal balance. For example in 1987 when oil prices dropped, state revenues plummeted from 42.6 billion US \$ to 20 billion US \$ point (Champion, 1999).

Therefore, Arabia Five-Year Development Plan was formed which aimed to cut the country's deficit with the help of the IMF. Saudi Arabia also decided to become part of the WTO in 2002 and changed the atmosphere of international trade became more competitive in the country. The country is also characterized by aspects such as the privatization of economic globalization, the flow of capital through FDI and the establishment of cooperation created through regionalism Gulf Cooperation Council (GCC). Seeing the above conditions, realized from the oil wealth, geopolitically, the geostrategy of Saudi Arabia tending to approach foreign oil will continue to find profitable customers.

The decline in oil prices of 107 US \$ per barrel to 44 US \$ per barrel today has hit the economy of Saudi Arabia. The reason is because 80% of government revenue is generated from the oil industry. The declining in oil prices occurred because of this happened because of the global supply, while world oil demand is decreasing.

In respon to this crisis, the Saudis will continue to maintain its strategy of making oil prices to fall even though Saudi oil reserves are very overflow and refusing to cut the production. However, Saudi has the goal of this strategy in playing weaken the strength of their opponent in oil market, which is United States with their shale oil production and the other oil producing countries. Saudi Arabia is simply ready to take the risk of an oil crisis that we experienced since 2014 until today. Saudi felt strong enough to maintain their strategy because of all

debts from the impact of declining oil prices is covered by foreign exchange reserves.

With their oil export resources, Saudi Arabia should be able to choose which global market is more profitable for them to fight in this oil market war. Therefore, technically, Saudi Arabia is competing with the other oil producing countries to direct their crude oil exports.

To make the market back to them, Saudi Arabia must ignore the United States market because United States's crude oil does not represent a threat to Saudi Arabia's crude export market, as America is a crude oil importer. Therefore, directing the export market of crude oil into the United States market will not improve the position of Saudi Arabia's competition in other's region market.

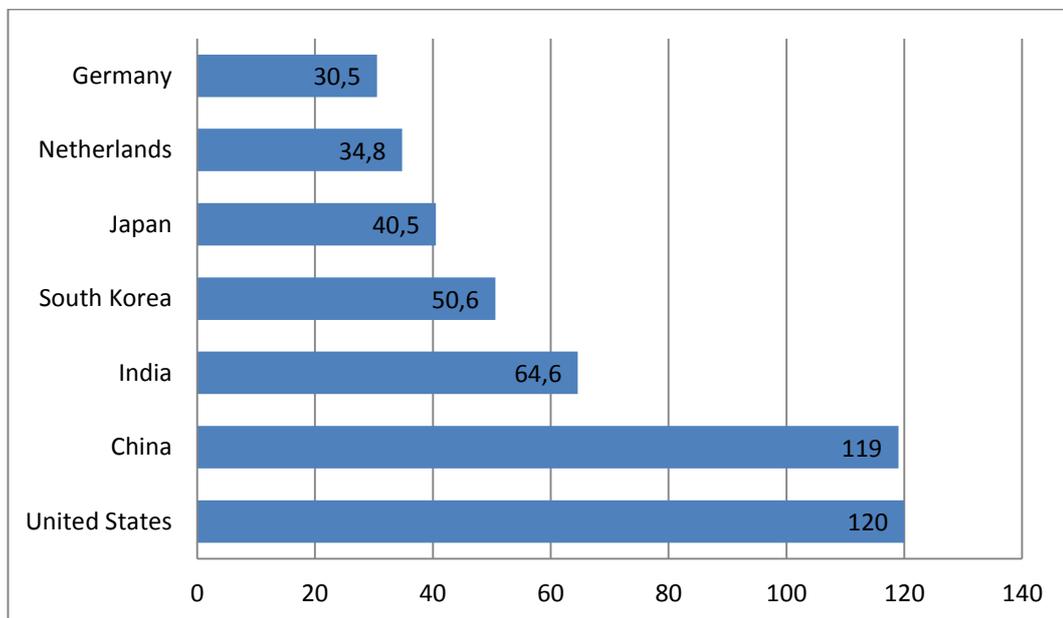


Chart 4.1
Import in Crude Petroleum in Billions US\$ 2015 (Observatory of Economic Complexity , 2015)

The consideration of their new market is the Asian market. With Asian status as Saudi Arabia's main oil consumer it is very important for the kingdom to maintain its market share in the region. Saudi may lose its share if it holds its oil at a high price because China, as the second largest importer after the US, is experiencing economic downturn. China's economy has declined due to the collapse of financial markets triggered by declining property and infrastructure markets in the country. It is also experienced by India which is the fourth largest oil consuming country. In addition Russia is reportedly ready to take advantage of China's economic downturn that could cause a domino effect to other Asian countries with its offer of oil at a cheaper price.

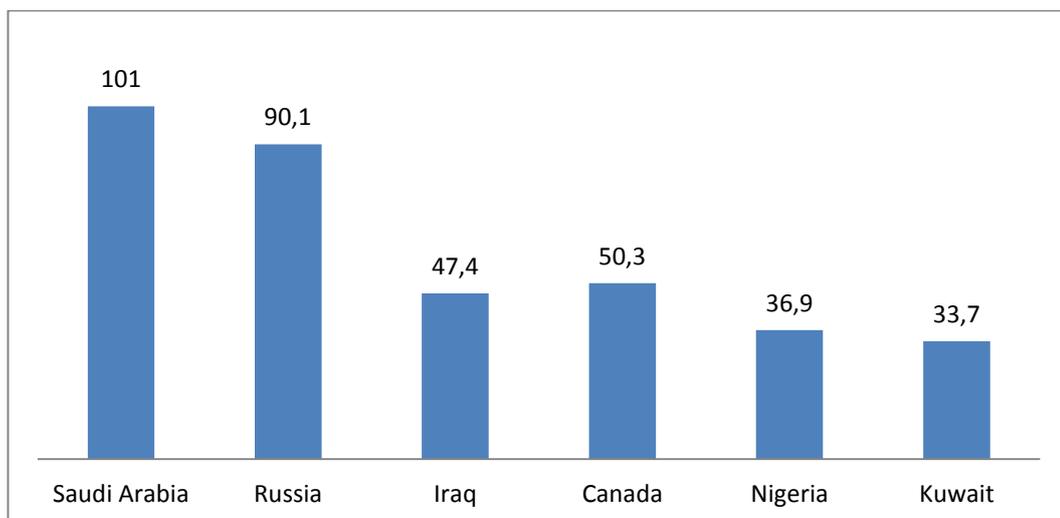


Chart 4.2
Export in Crude Petroleum in Billions US\$ 2015 (Observatory of Economic Complexity , 2015)

Furthermore, as has also been explain before, there is possibility of Saudi tackling the United States (US). The condition of the declining of world oil price

as it, is now very profitable US considering its status as a net oil importer. However, if viewed from a different point of view, cheap oil can also be a burden for the US.

However, the US remains one of the largest oil producing countries in the world, which of course has an interest in the cost structure. Low oil prices can impact on inefficient production costs, especially with their production conditions that continue to increase from year to year. With Saudi attitudes that let oil prices continue to decline like this, the various international oil companies (IOC) are threatened with bankruptcy and the US aspiration to reach independence in the energy field will be hampered. This is probably in line with Saudi interests, given that the US contribution to Saudi Arabia's oil revenues is considerable.

Finally, Saudi Arabia can focus on sustainable long-term gains in markets that are different from global crude oil export markets, with higher added value and therefore a market of petroleum products that is more valuable than strengthening markets in a single region. Saudi ARAMCO has set a target of doubling its global and domestic refining capacity to 10 million barrels per day by 2025. (Sfakianakis, 2017) Crude oil revenues will suppress what governments should spend on their oil industry and, perhaps, they should prioritize maintaining output from crude oil rather than investing in oil refines.

B. Vision 2013 as Saudi Arabia's Economic Rescue

The Kingdom of Saudi Arabia is determined to give up its economic dependence on oil. To counter the decline in revenue from these oil prices, Saudi

Arabia's cabinet has passed an overall economic reform. The reform was given the name of the Saudi Vision 2030. It has become one of the key points raised in Saudi Arabia's Vision 2030 drawn up by the Council of Economic Affairs and Development chaired by Prince Mohammed bin Salman. The vision was approved by the Saudi Arabian Cabinet Council on Monday, April 25, 2016 in Riyadh. (Vision2030, 2016)

Saudi Vision 2030 sets goals for the next 15 years along with a policy agenda known as the National Transformation Plan. According to that vision, Saudi Arabia is directed to release its dependence on oil by 2020.

Under the program, by 2030, non-oil exports are expected to increase 50% or six-fold from US \$ 43.5 billion to US \$ 267 billion through cuts in energy use and subsidies. The reforms were also made to make the Saudi Arabia become the 15th richest country in the world after being ranked 19th. The openness was marked by an Initial Public Offering (IPO) of less than 5% of the world's largest oil company Arabian American Oil Company (Aramco). Through the IPO, the Saudi government hopes to raise funds worth US \$ 2 trillion-US \$ 2.5 trillion or the largest value of IPOs in the world. (Vision2030, 2016)

The launch of the Saudi Vision 2030 is an ambitious royal plan to transform the economy from petroleum dependence enjoyed by the people over the years. The International Monetary Fund (IMF) considers this plan an ambitious effort and not easily achieved. Therefore, the IMF also warned Saudi

Arabia of the various challenges that will be faced. As a diversion from the oil sector, attention is paid to the more important quality of Human Resources (HR).

The Kingdom of Saudi Arabia is working hard on the post-oil state and preparing a clearer roadmap for the country's future. Preparation to reduce dependence on oil is accompanied by Saudi efforts to intensify the diversification of state revenues.

The declining of oil price is one of the main reasons for the economic change, but the Prince Mohammed said that the draft of this proposal has the objective to handle long-term economic reforms regarding the market price of oil. The basic aim of the vision is to reduce the importance of oil to the economy of Saudi Arabia. Various kinds of government subsidies will be reduced, including electricity, fuel and water. Some of the retail price will increase in 2015. To directly fulfill the revenue shortfall because of the Saudi Arabia's strategy which is declining the oil price to dominate the oil's market from their entire rival, the government will propose a more of loans if their foreign exchange reserves can't fulfilling the revenue shortfall.

Saudi Aramco, a company owned by the Saudi Arabian government, plans to release its shares in the stock exchange or to conduct an Initial Public Offering (IPO). The release of shares of energy companies to the public is claimed to break a new record beat Alibaba. Because even if the ARAMCO were to sell just 5% of its share of its \$2 trillion valuation, the Saudi ARAMCO would blow current record of IPO holder by Alibaba down from become the top of the chart.

Therefore, it is such a big gap between Saudi ARAMCO and Alibaba, approximately about 78,2 billion \$.

The Saudi Arabian government alone estimates Saudi Aramco's worth of \$ 2 trillion. The plan, the Arab government will release 5 percent or about US \$ 100 billion. It will amount to 4 times the value of the proceeds of Alibaba's general offer in 2014.

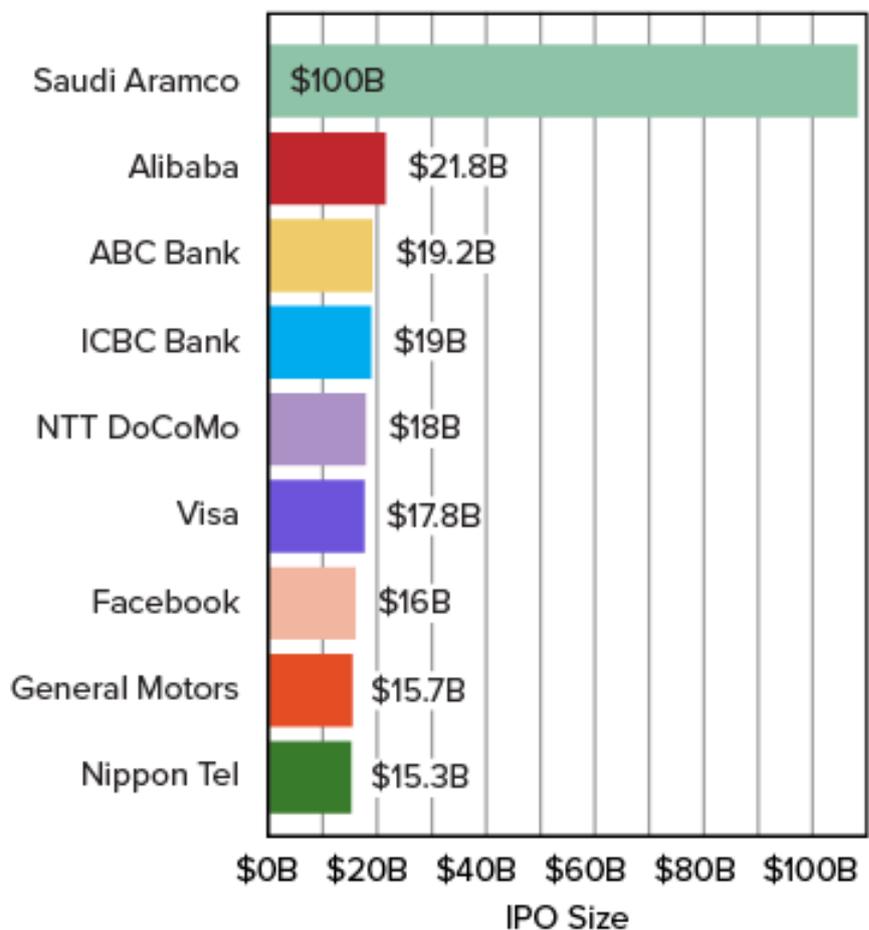


Chart 4.3
The 10 Biggest IPOs in History versus Saudi ARAMCO IPO (Merrifield, 2017)

The company plans to increase its refining capacity following production of about 10 million barrels by 2030. Saudi Aramco will also invest more than US \$ 300 billion for the coming decade. To note, Alibaba release shares in 2014. This corporate action became the largest IPO in the history of the article raised funds reached US \$ 25 billion. Until now Alibaba IPO action is the release of shares with the greatest value in the world.

To sell Aramco's shares in public stock, Aramco should be more transparent about their income, expenses, and other aspects of their management relevant to prospective shareholders. The interesting part is that Aramco was a private company back then, before Aramco was nationalized four decades ago.

Facing with this problem, Saudi Arabia has issued a policy which is open their foreign stock markets and foreign investment. However, due to the difficult terms and provisions make Saudi Arabia, such as like the lack of transparency in applying the laws of intellectual property, imposing quotas of Saudi employee in the company, the cultural traditional environment of conservative, including the separation forced on gender in most business and social settings (Santander TradePortal, 2017). Due to the system followed by Saudi Arabia is sharia law that implements a system of religion, making it difficult for foreign investors to enter their markets.