

Key Points

Jamal Khashoggi – writer, journalist and outspoken critic of Saudi politics – disappeared on 2 October during a visit to the Saudi consulate in Istanbul. Riyadh has since confirmed the death of Khashoggi and claim he was killed in a ‘fist fight’ during a ‘rogue operation’.

The Khashoggi Affair could have serious implications on Saudi Arabia relations with the United States (US). However, **in AKE’s baseline case, the Khashoggi Affair will temporarily strain relations** between Washington and Riyadh, but the countries’ interests are likely to remain sufficiently in line – despite increase domestic shale production in the US – and, **as with past disputes, relations are likely to normalise**.

The imposition of **harsh measures (either sanctions or restrictions on arms sales) targeting Riyadh by the US and other states is dependent on several key variables**. The foremost two issues are: how Turkey handles the affair with Ankara releasing information that undermines the Saudi narrative of events over Khashoggi’s killing; whether there is concrete evidence linking Saudi Crown Prince Mohamed bin Salman (MbS) to Khashoggi’s killing.

Serious US sanctions that may be imposed would come under the ‘Global Magnitsky Act’. 22 Senators have sent a letter triggering a Magnitsky Investigation. **It will remain a political decision whether the Trump Administration enacts sanctions and the authority to do so rests with the White House**.

The Trump Administration has vacillated on its willingness to impose serious sanctions on Saudi officials. On 23 October, the US State Department barred 21 Saudi citizens from entry into the US. These measures are largely symbolic.

President Trump is reticent to limit the sale of arms to Saudi Arabia. Trump has suggested that arms deals with Saudi Arabia are too valuable to risk. It is plausible that the Administration will be swayed from its position, as other members of the Administration are known to be more critical. **The risk of disruption to such deals with other Western countries is higher and Germany has already suggested that it would suspend arms sales to Saudi Arabia**. There are existing movements advocating Saudi arms sales’ bans in Canada, the UK, Spain and France among others.

In the event of harsh punitive measures by Washington, **Saudi Arabia could deploy its so-called ‘oil weapon’**. While Riyadh is unlikely to impose an embargo on the sale of oil, as it has stated, it could fail to increase oil output. With sanctions on Iran coming into effect on 4 November, that **could increase prices to US\$95+ a barrel**. A cut in supply or a total embargo could result in oil prices **reaching more than US\$200 per barrel**.

While there may be some **short-term reticence for firms selling equity stakes to Saudi Arabia’s Public Investment Fund, (PIF) or associated entities** due to reputational and moral concerns, **given the sums of money involved this will likely blow over**. However, **inward investment is likely to fall further, and threatens MbS’ Vision 2030**, his agenda for reforming the Kingdom and its economy.

About us

AKE has over 20 years of experience working with the financial sector, providing clients with political and economic risk consultancy. Our experienced team provides tailored analysis and strategic forecasting, allowing our clients to better assess risks in challenging environments.

Timeline

28 September 2018

- Jamal Khashoggi enters Saudi Consulate, Istanbul

2 October:

- 03:28: Saudi private jet arrives at Istanbul airport.
- 05:05: A group is seen checking into hotels near Saudi consulate.
- 12:13: Saudi diplomatic vehicles filmed arriving at the consulate
- 13:14: Khashoggi enters the Saudi consulate in Istanbul.
- 15:08: Vehicles leave the consulate, arrive at consul's residence.
- 17:15: A second Saudi private jet lands in Istanbul.
- 18:20: One of the private jets departs from Istanbul airport.
- 21:00: The other plane leaves.

3 October

- Financee and Washington post go public on disappearance
- Talks begin between Ankara and Riyadh
- MbS states Khashoggi left consulate safely

4 October

- Turkey summons Saudi ambassador

6 October:

- Anonymous Turkish officials report murder and dismemberment
- Saudi dispatches team to investigate

7 October

- Turkish officials say Khashoggi was killed at the consulate

10 October:

- 22 US senators trigger Magnitsky Act investigation
- Footage leaked of high profile Saudi 15-person 'death squad'

11 October:

- Ankara – Riyadh form a joint task force
- Ankara claims to have audio recording of death

12 October:

- Trump rules out halting weapons sales
- Surprise release of US pastor Andrew Brunson

14 October

- Trump warns of 'severe punishment' if MbS involved

15 October:

- Turkish investigators allowed first access to consulate
- King Salman blames 'rogue killers'

16 October:

- Saudi consul leaves Istanbul
- US Secretary of State Mike Pompeo meets Saudi King Salman, MbS

17 October:

- Turkish investigators search consul's house
- Pompeo meets Erdogan

18 October:

- US Treasury Secretary pulls out of conference

19 October:

- Saudi foreign minister confirms death in 'fist fight'
- Senior intelligence officials fired

20 October:

- Riyadh states five top officials fired including MbS advisor
- King Salman reshuffles intelligence agency under MbS

22 October:

- Berlin freezes arms sales to Saudi
- Riyadh rejects possibility oil embargo
- CIA director flies to Turkey

23 October:

- Erdogan makes speech questioning Saudi narrative
- Trump denies or revokes 21 Saudi officials' visas
- Tump accuses Saudi of 'the worst cover up ever'
- CIA director hears audio recording of murder

25 October

- CIA director briefs Trump
- Saudi Arabia's public prosecutor says the murder was 'premeditated'

Overview

Jamal Khashoggi – writer, journalist and outspoken critic of Saudi politics – disappeared on 2 October during a visit to the Saudi consulate in Istanbul. Khashoggi, in self-imposed exile in the US since 2016, entered the consulate to finalise paperwork for his impending nuptials. Sources from inside the consulate initially reported that he had been killed and dismembered there, while official Turkish sources alleged he was being detained within the building. Saudi officials refuted such claims, instead claiming that Khashoggi had left the consulate safely after his meeting, however did not (or could not) produce any evidence to support this. Riyadh has since confirmed Khashoggi's death, asserting that he was killed in a 'fist fight' during a 'rogue operation'. No proof has been forthcoming.

Saudi authorities superficially, and belatedly, cooperated with Ankara's request to search the consulate, but this did not prevent members of the US Senate triggering a provision of the Global Magnitsky Human Rights Accountability Act requiring the president to determine whether a foreign person is responsible for a gross human rights violation. An audio recording of Khashoggi's last, tortured, moments supposedly exists but has not been independently verified.

A press conference was held on 23 October by Turkish President Recep Tayyip Erdogan in which it was touted that he would reveal details of the Turkish investigation that may undermine Saudi's story. Erdogan's did little to elucidate matters. Notably absent from his speech was any mention of Saudi Crown Prince Mohammad bin Salman, frequently referred to as MbS. Instead the president stressed the closeness of Turkey's ties to Saudi King Salman and reiterated the desire to get to the bottom of the affair. Ankara's release of US pastor Andrew Brunson as well as cooperation with the investigation may see US sanctions on Turkey imminently lifted.

Jamie Dimon of JPMorgan Chase, Masayoshi Son of Softbank, and the CEOs of Uber and Siemens (among others) have withdrawn from a high-profile investment conference in Riyadh and Saudi's stock market has taken a hit. Germany has now halted weapons sales until the case is resolved.

The Trump Administration offered a mixed response. On 23 October, the US State Department barred 21 Saudi citizens from entry into the United States, the first punitive measures taken by President Donald Trump against Saudi Arabia in the Jamal Khashoggi affair. Trump accused the

Saudi's of the 'worst-cover up' event and admitted for the first time that Crown Prince Mohammed bin Salman could have been involved, stating: 'the prince is running things ... and so if anybody were going to be, it would be him'. US Secretary of State Mike Pompeo did not rule out imposing Global Magnitsky Act sanctions, indicating that there would be further action while stating that Saudi Arabia remains an important ally.

A closer inspection of Saudi-US relations demonstrates that there is little precedent for US sanctions to be imposed upon the country. Ties between the current US President Donald Trump, his son-in-law and Special Advisor to the White House, Jared Kushner and MbS seem to be the closest yet between a US administration and Saudi leader. Nonetheless, there is a higher degree of uncertainty over what the Trump Administration will do, and President Trump can be unpredictable.

Saudi's finance minister has assuaged worries of a retaliatory oil embargo, which in 1973 saw oil prices quadruple. Thus, should MbS's involvement be directly proven, a point that the Saudis adamantly deny, the intractable relevance of Riyadh's economic power and strategic importance to the US will most likely make any punishment purely symbolic.

While MbS's reputation and international legitimacy has been weakened by the Khashoggi killing, he appears to remain powerful within the Kingdom and has consolidated his power over the last 18 months. Projections that Crown Prince may yet step down are also contradicted by the reformation of Saudi's intelligence services underneath him, which should further solidify his power.

US-Saudi Historical Relations

The US has a long and complicated history with Saudi Arabia. Over the last 80 years, relations between the two states have been strained due to myriad factors. Nonetheless, Washington's objectives of securing the free flow of crude oil and maintaining stability in the Gulf have ensured continued cooperation between the two countries.

The Khashoggi affair could temporarily strain relations between Washington and Riyadh, but the countries' interests are likely to remain sufficiently in line – despite increased domestic shale production in the US – and, as with past disputes, are likely to normalise in the medium term.

US – Saudi relations officially started in 1931 and continued since to develop. Saudi's oil giant Aramco was initially a subsidiary of Standard Oil of California (SOCAL, later Chevron) and the Texas Company (Texaco), which started shipping oil in commercial quantities in the early 1940s. The naming of the oil company in 1944 demonstrates the historical interconnectedness of the US – Saudi ties: Arab American Oil Company, or Aramco. With the establishment of Aramco, much US technology and manpower has been sent to Dharan to aid construction of the company's oil wells.



Franklin D. Roosevelt and King Ibn Sa'ud of Saudi Arabia, 1945

The US in the 1940s started habitually funding the Saudi royal deficit. Once oil sales had begun, Aramco provided advances in royalties to the Saudi king, 'Abd al-'Aziz Ibn Sa'ud, from oil sales, with the US state to absorb a large share of this cost. The US government consequently took steps to replace the British as sole protectors of Saudi Arabia. As the strategic importance of oil began to dawn on the world, US President Franklin Delano Roosevelt in 1943 stated that 'the defence of Saudi Arabia is vital to the defence of the United States'.

In 1950 Saudi Arabia and Aramco agreed to a 50–50 profit-sharing arrangement after threats that Riyadh could nationalise the company. The new profit-sharing agreement was followed by the signing of a mutual defence agreement in 1951 under which the U.S. established a permanent US military training mission in the Kingdom.

US global security commitments meant that by the 1970s President Nixon was hesitant to have too many troops stationed in the Gulf. US strategy involved and relied on Saudi Arabia and Iran as 'twin pillars' of regional security. US military aid to Saudi over this time increased dramatically from less than US\$16m in 1970 to US\$312m by 1972.

An ideological difference over Israel following the Yom Kippur War resulted in a Saudi-imposed oil embargo on the US and several other major Western states for six months between 1973 – 1974, causing an energy crisis. Three months after lifting the embargo, Washington and Riyadh signed a wide-ranging agreement on expanded economic and military cooperation. In the 1975 fiscal year, the two countries signed US\$2bn-worth of military contracts, including an agreement to send Saudi Arabia 60 fighter jets. A further series of agreements between 1973-80 resulted in Saudi gaining control of Aramco.

Consequently, Saudi and the US worked in tandem, with Saudi maintaining oil production to stabilise the oil price as the US sent F-15 fighters to the Kingdom, which became an ally against communism in the region. Following the 1979 Iranian Revolution, Saudi Arabia became the US prime strategic ally in the region, jointly supporting anti-Soviet groups in Afghanistan. Saudi remains the strategic ally for the US in the region to counter Iranian influence and efforts will be taken to maintain this cooperation. Oil prices doubled during the revolution although global supply only dropped by around 4 per cent.

The threat to Gulf and Saudi oil caused by Iraq's invasion of Kuwait in 1990 catalysed prompted retaliation by US forces, in line with the historical dictum that in 'the Gulf, [the US] would oppose domination of the Gulf region by any single power', thus protecting US vital interests in the region. Operation Desert Shield – the US's operation to defend Saudi against Iraq's invasion – ran alongside the better-known Desert Storm, the operation to expel Iraqi forces in Kuwait. This further cemented US – Saudi security cooperation.

Diplomatic relations became extremely frayed after the 9/11 attack. Although the Kingdom publicly denounced the attacks, and the US praised Saudi for their cooperation in the 'war on terror', Riyadh was not forthcoming in the investigation into the hijackers of the aircrafts, 15 of 19 of whom were Saudi nationals. Suspicion of Saudi supporting militant Islam is still a node of paranoia.

The US invasion of Iraq in 2003 caused further disputes between the two countries. Riyadh did not outwardly cooperate, as the invasion set a dangerous precedent of toppling a strong-man power, as well as deposing a Sunni government in the region. Thus the country took a neutral stance, not wishing to be seen providing a base for the invasion whilst maintaining the US-Saudi relationship.

In 2010 the US made the biggest arms sale in US history, selling US\$60.5bln worth of armaments to the Kingdom. Relations between President Barack Obama and the previous king 'Abd al-'Aziz bin Saud were some of the frostiest between a US president and a Saudi royal in their diplomatic history. The arms deal had been in the pipeline since the Bush Administration and came at a time of heightened fears regarding Iran's nuclear capabilities.

Relations deteriorated further upon Obama's stance on Syria following the 2011 Arab revolutions and a public condemnation over Saudi occupation of Bahrain to quash the revolts on the island. Obama also strained relations by his rapprochement with Tehran.

However, since the Trump Administration took power the relationship seems to have strengthen. The US President's first trip of his presidency was to Saudi Arabia, in May 2017, during which letters of interest were signed indicating intentions of arms deals of up to US\$110bln in weapons contracts (although the actual figure is substantially lower) between Trump and Saudi King Salman.

MbS, Trump & Kushner

The Trump Administration de facto backed MbS in the removal of former crown prince Mohammed bin Nayef, King Salman's nephew. It also supported his crackdown on political opponents and members of the Saudi elite, and the Saudi war in Yemen.

Jared Kushner, senior White House advisor and son-in-law to President Donald Trump, has been quiet on issues surrounding the Jamal Khashoggi affair. Kushner, a main architect behind the President's close relationship with MbS, took the lead in promoting Saudi's Crown Prince as a visionary prior to Trump's first visit to the Kingdom.

MbS and Kushner reportedly first struck up a friendship following MbS's visit to Washington in March 2017. That reportedly started a long-distance relationship, with frequent phone calls.

As a result, Trump flew to Saudi Arabia for his inaugural foreign trip as President in May 2017. The agenda for Trump's visit was organised partly by Kushner. Multiple agreements were reached during the trip, including billions in arms deal and Trump's attendance at the inauguration of the Global Centre for Combatting Extremist Ideology in Riyadh.

Kushner subsequently visited MbS in Riyadh in October 2017, ostensibly for discussions surrounding an Israeli-Palestinian peace deal. Reports came that during this visit, the pair chatted until 4am, shortly after which MbS arrested numerous members of his royal family, and extracted billions of dollars' worth of fines, a move which Trump endorsed on Twitter.

In November Palestinian Authority President Mahmoud Abbas was summoned to Saudi Arabia. Although details are vague, reports say that MbS pressed Abbas to accept Kushner's terms for a peace deal that would comprise a Palestinian quasi-state with a capital in Jerusalem's suburbs, as opposed to the city centre itself – a move that Abbas reportedly declined. Saudi statements denied that MbS had ever embraced such a proposal.

Following Kushner's trip Lebanon's Prime Minister Saad Hariri appeared in Saudi Arabia to resign on the 4 of November, citing Hizbullah's – the Lebanese Shi'ah militia aligned with Iran – overweening influence in his country. Hariri subsequently reappeared in Lebanon having rescinded his resignation. His resignation was thought to have been coerced by MbS to spark instability in Lebanon, and force an Israeli assault on Hizbullah as a proxy attack on Iran.



The Trump Administration, like the Obama Administration before it, largely supported Riyadh's brutal military campaign in Yemen. The Trump Administration was also supportive of MbS's crackdown on political opponents, as part of a corruption drive.

In March 2018 MbS returned to the US to meet with Trump and Kushner, who organised the itinerary including stops in high-tech centres on the East and West coasts to talk investment, with the prince's modernisation proposals under Saudi Vision 2030 receiving glowing attention from US columnists. Marring the visit was the revelation, first reported at the time by The Intercept, that MbS told GCC officials that he had Kushner 'in his pocket.'

Current reports indicate that Kushner's relationship with MbS is seen as a hindrance not an asset. Trump and the White House are trying to distance themselves from the history of support for the Crown Prince, but Saudi's strategic investments and history of weaponising the Kingdom's substantial wealth make any negative overtures by Washington diplomatically and financially difficult.

US Responses

The Khashoggi affair ignited controversy worldwide and could result in the imposition of punitive measures by Western governments against the Saudi regime. Given Saudi Arabia's economic and geopolitical significance it is plausible, and even probable, that the reaction by Western states will be largely symbolic.

Nonetheless, there is a strong movement in both the EU and the US Congress for harsher measures against the Saudis. However, in the US, the ability of Congress to impose punitive measures without the support of the President is limited.

The following section looks at some of the action's governments may take against the Saudi's and assesses the potential reaction in Riyadh.

Sanctions

Key Risks: Targeted sanctions on the Saudi elite

The US and EU may impose targeted sanctions on members of the Saudi elite. On 23 October the US State Department barred 21 Saudi citizens from entry into the US, the first punitive measures taken by President Donald Trump against Saudi Arabia in the Jamal Khashoggi affair. US Secretary of State Mike Pompeo indicated that harsher sanctions could be on their way.

The Process

In the US harsh sanctions would most likely come under the 'Global Magnitsky Act', which allows the government to pierce the veil of diplomatic immunity. The Global Magnitsky Act designation is in effect as strident as the specially-designated nationals (SDN) list, which is the main US sanctions designation that completely bars all financial relationships between US persons and the listed individual.

The Global Magnitsky Act authorises the government to place sanctions on human rights offenders, freeze their assets, and ban them from entering the US. The act also

allows individuals to be placed on the US Treasury's Office of Foreign Asset Control (OFAC) sanctions list, which means that any bank with business in the US will be obliged to bar the movement of money of a sanctioned individual.

The Act allows a chairman and ranking member of an appropriate House or Senate committee to trigger a Magnitsky investigation of suspected human rights violation. The president has 120 days to report back to Congress with a determination and a decision on the imposition of sanctions. The executive could also impose sanctions without a demand from Congress.

The act does not force an Administration to impose Global Magnitsky sanctions on any individual, even when clear human rights violations are publicly reported. The Administration could cite national security concerns for taking no action.

In the Saudi case, 22 Senators, including Senators Bob Menendez (D-NJ) and Bob Corker (R-TN), ranking member and chairman of the Senate Foreign Relations Committee, respectively sent a letter triggering a Magnitsky Investigation. Patrick Leahy (D-VT) and Lindsey Graham (R-SC), ranking member and chairman of the Senate Appropriations Subcommittee on State, Foreign Operations, and Related Programs also signed the letter. The Administration could decide to only impose serious sanctions on low level Saudi officials, based on claims that higher-up members of the regime are not complicit. There is nothing in the act that would obligate the Trump Administration to place sanction on MbS or any other high-ranking Saudi official. However, there would be considerable public pressure on the Trump Administration to act.

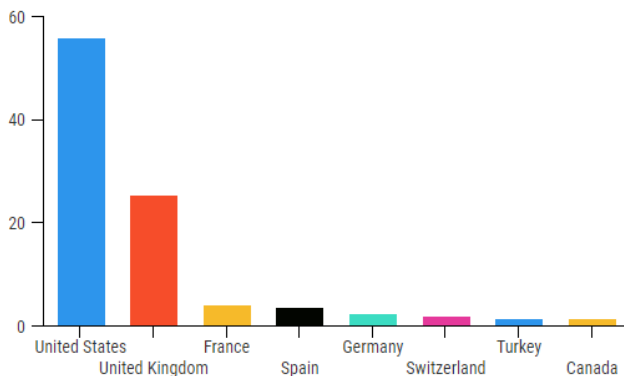
Furthermore, a signing statement by former president Barack Obama suggested that the Global Magnitsky Act represents an unconstitutional encroachment of executive power, as the separation of powers limits Congress' ability to dictate how the executive branch executes a law. President Trump has issued signing statements that are even more critical in response to sanctions legislation passed during his presidency. The constitutionality of the act has yet to be tested in court. However, given the challenges for any sanctioned individual to pursue an extended legal process required to test it, and the politics around sanctions in the US that mitigate the chance the White House will seek to challenge these authorities, it is unlikely that a challenge will be forthcoming in the foreseeable future.

Arms' Sales

Key Risks: Non-granting of export licences; cancellation of current arms contracts; ban on future sales

Saudi Arabia is the world's third largest importer of arms (behind India and China). It is also the biggest foreign recipient of American-made weapons, and dependent on US weapons imports.

Saudi Arms Imports 2010-2017 (% of Total)



Source: Stockholm International Peace Research Institute

The impact of prohibiting Western weapons sales to Saudi Arabia would be significant. Reports indicate that the Royal Saudi Air Force (RSAF) is entirely dependent on US and British support for its F15 fighters, Apache helicopters, and Tornado Aircrafts. Halting the flow for logistic could result in the grounding of the air force in weeks. The army and national guard are similarly dependent on the continued purchase of spare parts and services from western states.

The Process

President Donald Trump is reticent to limit arms to Saudi Arabia. Trump has suggested that arms deals with Saudi Arabia are too valuable to risk, claiming on 20 October that ending the sale of arms would 'hurt us far more than it hurts them.'

It is plausible that the Administration will vacillate from its position, as other members of the Administration are known to be more critical. However, Trump has repeatedly cited a US\$110bln arms deal with the Saudis – though it has not been finalised – and claimed that cancelling weapons sales could cost a 'million jobs'. These figures are seriously inflated. Bloomberg has calculated that the US\$110bln arms deal could be worth less than half that amount, and involves counting letters of intent and interest, rather than completed deals. CNN has claimed that of the US\$110bln that Trump announced in May

2017, Saudi Arabia has only confirmed US\$14.5bln in purchases.

If the Administration is unwilling to act, Congress has some power to force its hand. The 1976 Arms Export Control Act allows Congress some power to prevent the sale of major weapons to foreign countries. The Act creates a duty to notify Congress at least 30 days before a major transfer of defence equipment or services to a non-NATO member.

During that period, Congress could pass legislation to block the sale, but doing so would be subject to a presidential veto. The Primary impact of congressional legislation, absent a supermajority to override a veto, primary impact is to place increased pressure on the executive to take action. That action would likely involve a modification of what is sold, or a delay in sales.

Other Countries

On 21 October, German Chancellor Angela Merkel stated that 'arms exports can't take place in the situation we're currently in'. According to its annual EU declaration, Germany sold about EUR530m of mostly aircraft equipment to Saudi Arabia in 2017 and has already approved some EUR300m in such sales this year. The UK and France export even more arms to Saudi Arabia. German Economics' Minister Peter Altmaier called for other European countries to also halt such sales. On 21 October, France and the UK released a joint statement with Germany, which indicated that they are considering similar punitive action. However, neither have yet followed Berlin in suspending arms sales to Saudi Arabia.

The Khashoggi affair is superimposed on an environment in which various states were already reconsidering their sale of weapons to Saudi Arabia over questions regarding war crimes in Yemen. For example, the Social Democrats, the junior coalition partner in the German government, demanded Berlin halt new arms sales to Saudi Arabia when it agreed to enter a new coalition with Merkel earlier this year and numerous party members have voiced complaints over the 'pre-approved' EUR300m for such deals this year.

While governments in general are unlikely to be willing to cut their sales to the Gulf state dramatically, there are legal and political methods that could deny export licences to those selling arms to Saudi Arabia. The power of a legal challenge was shown in 2016, when University of Montreal law professor Daniel Turp challenged an export permit granted to General Dynamics to supply US\$15bln of light-armoured vehicles to Saudi Arabia.

The General Dynamics deal was widely covered in insurance markets and put on hold while awaiting a Canadian Federal court ruling. The Court eventually ruled that the Canadian government had the right to decide on whether to award the export licence, and thus allowed to export to proceed.

In September 2018, Spain's Defence Ministry launched a process to cancel a 2015 contract between Spain and Saudi Arabia for the delivery of 400 laser-guided munitions, given the Kingdom's potential violations of international humanitarian law in the war in Yemen, intending to repay US\$10mln already paid for the weapons. The Spanish government was halting this sale over concerns about Riyadh's use of missiles against civilians in the war in Yemen, although they later backtracked on the decision, citing a desire to uphold decisions by the previous government.

In the UK the Campaign Against Arms Trade has challenged the government's policy as has a court hearing on halting the export of arms to Saudi Arabia scheduled for April 2019. Both challenges are rooted in concerns over potential war crimes that the Saudi-led coalition is committing in Yemen and its domestic human rights abuses. French NGOs have also challenged the sale of arms to Saudi Arabia. These challenges are likely to gain increased steam, and weapons sales are likely to become increasingly politicised.

Key Variables

The imposition of harsh measures (either sanctions or restrictions on arms sales) by the US is dependent on several key variables:

Turkey: Turkey has provided evidence contradicting Saudi Arabia's official narrative over the death of Jamal Khashoggi. Local press has indicated that Ankara possess audio recordings to verify their claims, although there is no independent verification of the existence of such evidence. Turkish President Recep Tayyip Erdoğan has continued to drip feed information undermining Saudi Arabia and the Crown Prince in particular. The release of further information could make it hard for Washington to whitewash the involvement of the Saudi elite and could galvanise support of an aggressive response in Congress.

AKE's sources in Turkey and within the ruling AKP indicate at least three motives of Erdogan's actions. Firstly, Erdogan sees Saudi Arabia as a strategic rival. The two countries have opposed views on the Muslim Brotherhood, and Turkey remains close to Qatar. Turkey

hopes to use the Khashoggi affair to undermine the Kingdom in the international community. Secondly, there is anger in Ankara that Saudi Arabia would conduct the killing in Istanbul. Thirdly, one of Erdogan's close aids, Yasin Aktay was a close friend of Khashoggi. Reports suggest that Khashoggi believed his connections with Aktay gave him protection. Saudi action is thus seen to show a lack of respect towards the President.

MbS complicity: There is circumstantial evidence that suggests MbS is complicit in the murder of Jamal Khashoggi. Khashoggi had been publicly critical of the Saudi government and MbS in particular. There are credible accusations that Saud al-Qahtani, a top aide for the Crown Prince, orchestrated Khashoggi's killing via Skype. It is unlikely that he would act without MbS's knowledge. Qahtani has since been removed from his position. Furthermore, members of the team sent to Istanbul to kill Khashoggi were identified by Turkish officials as members of the Royal Guard that personally protects MbS.

US Senators, including Lindsey Graham, have blamed MbS for the killing. Even President Donald Trump admitted that MbS could have been involved, stating: 'the prince is running things ... and so if anybody were going to be, it would be him'. Nonetheless, there is no smoking gun that links the Crown Prince directly with the murder. If such evidence is uncovered, Congressional and public pressure could make it difficult to avoid serious punitive action against Saudi Arabia.

Donald Trump: The Trump Administration has vacillated on its willingness to impose sanctions on Saudi Arabia. President Trump can be erratic, and it is plausible that individuals in the cabinet or media reports could push him to take more radical action. Unlike with previous administrations, it is uncertain whether action would be driven primarily on the basis of an objective assessment of the US's strategic interest. Trump's relationship with MbS mitigates the risk of the imposition of serious sanctions. However, Trump has regularly spoken about his friendship with Chinese President Xi Jinping yet has still imposed heavy tariffs on China. In other words, the actions of the Trump Administration are not entirely predictable.

Congress: Congress appears to have a much stronger stance on the issue than Donald Trump. Congressmen and Senators from both parties have demanded action against Saudi Arabia.

If the Trump Administration is unwilling to impose sanctions on Saudi Arabia, Congress could still directly mandate the imposition of punitive measures.

These measures, however, would be subject to a presidential veto. Separate legislation would be required to override the veto, requiring a two-thirds majority in both houses of Congress. Nonetheless, Congress could still place considerable public pressure on the President to act.

Saudi Arabia's 'Oil Weapon'

On 14 October, Turki al-Dakhil wrote on Saudi state-owned news service Al Arabiya that: 'decision-making circles within the Kingdom have ... [discussed] more than

BRENT CRUDE PRICE



US\$75 – 12 month projection
KSA increases production and exports

30 potential measures to be taken against the imposition of sanctions on Riyadh" if the US moves ahead with such measures. Dakhil wrote such measures would "present catastrophic scenarios that would hit the US economy much harder than Saudi Arabia's economic climate". The statement was almost certainly authorised by senior Saudi officials and threatened to disrupt global oil markets in retaliation to US action. Riyadh under MbS has a history of rash action against allies. First Sweden in 2015, followed by Germany, then Canada in August 2018 over critiques of Saudi's poor human rights record, which Riyadh sees as "foreign meddling" in domestic affairs.

The Kingdom subsequently backed away from Dakhil's statements and on 22 October Saudi Arabia's Energy Minister Khalid al-Falih stated that the country has 'no intention' of using oil as a tool to pressure the international community. However, Falih warned that the Kingdom should be appreciated for its attempt to reign in oil pricing by increasing output, an implicit warning that

Saudi Arabia could choose not to act to prevent oil prices rising further.

Saudi Arabian Production

Key Risk: Saudi Arabia fails to increase oil output; prices rise to US\$95+ a barrel

Saudi Arabia has considerable power in the oil market. It is currently producing around 10.7m barrels per day (bpd) and is the only major player with the ability to ramp up production. Production levels have been hit by a crisis in Venezuela. Sanctions on Iran, which are due to come into effect in November, could also reduce global oil exports by around 1.5m barrels per day. Saudi has some power to reduce the effect on price of the reduction in supply by increasing its own production level. Since the start of the year, Saudi Arabia has been increasing oil production – in part to control to rise in oil prices and seemingly at the behest of President Trump. If Saudi Arabia is willing and able to increase production, AKE forecasts that ceteris paribus, Brent crude prices would stabilise at around US\$75 per barrel.

There are disputes about the Kingdom's spare capacity. Saudi Arabia has claimed it has the ability to increase production to 12m bpd from its current level of 10.7m bpd – already the joint highest level recorded. However, it is plausible that that it would struggle to produce more than 11m bpd without significant investment. It may, however, have increased ability to increase output in early 2019 when the Manifa field comes back on line and could add another 300,000 bpd when the expansion of the Khurais field is completed in mid-2019. Nonetheless, the Saudis have huge power over the market given the global lack of spare capacity.

BRENT CRUDE PRICE



US\$95 – 12 month projection
KSA does not increase production and exports

A failure to increase Saudi oil production could have a huge impact on the oil market. Prices would likely rise dramatically. From the US' perspective, a rapid rise in oil prices could slow growth. A price risk could threaten its strategy to isolate Iran. At oil prices above US\$100 per barrel, it could be difficult for Washington even to get allies, like India, to dramatically scale back on their imports of Iranian oil. Riyadh is supportive of US action against Iran, which mitigates Riyadh's willingness to play the oil card.

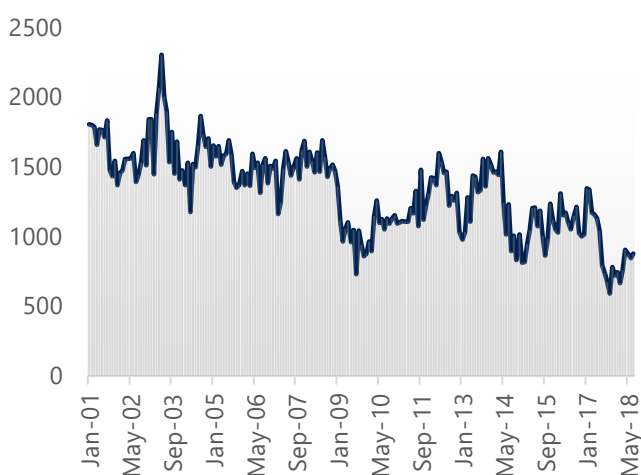
AKE believes that any substantial action by Washington against the Kingdom will likely result in Saudi Arabia limiting its attempts to control the price of crude oil. A conservative estimate would suggest that such Saudi action would result in the oil price rising to around US\$95-100 per barrel over the medium term. In contrast, limited US action would likely result in Saudi Arabia continuing to increase output to keep prices in check.

Oil Embargo

Key Risks: Saudi Arabia cuts output; prices rise to US\$200+ a barrel

Saudi Arabia also has more extreme options. The worst-case scenario includes a complete embargo on the sale of oil to Western countries. While Saudi Arabia has claimed that it has no intention of taking such measures, the risk cannot entirely be ruled out.

US Imports from Saudi Arabia of Crude Products (bpd)



A complete embargo would damage the US economy significantly. While US shale oil production has increased dramatically, the country still imports 7.9m bpd, with around 880,000 bpd coming from Saudi Arabia. Saudi Arabia is still the US' second most important supplier of oil, trailing only behind Canada. Many of the US' Gulf Coast refineries are unable to use shale oil, and instead require medium and heavy grades of crude. It is thus

impossible for many US refineries to shift from Saudi crude to shale in the short and medium term.

It is difficult to predict the impact of a Saudi embargo over the medium term. It is likely that prices would rise to at least US\$200 per barrel, although the actual figure could be considerably higher.

BRENT CRUDE PRICE



US\$200 – 12 month projection
KSA embargo on Western Countries

An oil embargo would be counterproductive in the long term and could damage the Kingdom's economy. The 'oil weapon' would hurt Western states, but it is emerging economies that would be most affected. Furthermore, an embargo would likely result in countries diversifying their sources of imports of oil away from Saudi Arabia, as the Kingdom would have lost its reputation as a reliable supplier, as well as accelerate the shift away from oil and towards other sources of energy. An embargo would also harm Saudi Arabia's shared interest with the United States in isolating Iran.

The Saudi Economy

On 23 October, Saudi Arabia's second edition of the Future Investment Conference, dubbed 'Davos in the Desert,' started. The 2017 conference, hosted by Saudi Crown Prince Mohammad bin Salman, attracted the likes of IMF Chief Christine Lagarde and the heads of numerous major financial institutions. However, the fallout from the Khashoggi affair has seen the CEOs of SoftBank, JPMorgan Chase, Uber and Siemens drop out of the conference, among other prominent names. Such withdrawals raise fears that Saudi oil giant Aramco will not be able to raise funds for its planned acquisition of SABIC, due to be announced before the end of 2018.

Saudi Arabia's financial strength means that in the medium term international companies will continue working with Riyadh. Companies will continue to take money from Saudi Arabia, and financial institutions will continue to arrange financing for the Kingdom. Nonetheless, the Khashoggi affair could do longer-term damage to the Saudi plans of economic diversification. The harm will likely result from a further slowdown in inward investment, which will make it harder for Saudi Arabia to increase domestic employment opportunities and develop new sustainable drivers of growth.

Saudi Investment Abroad

The Public Investment Fund (PIF) is the country's core global investment vehicle. PIF, formed in 1971, was a passive entity that held much of the state's equity in listed firms. The company has stake in chemicals producer Sabic, National Commercial Bank, Saudi Telecom, amongst others. The Kingdom's petrodollar wealth was managed by the Saudi Arabian Monetary Authority (SAMA), which largely invested in liquid assets. Since March 2015, under Crown Prince Mohamed Bin Salman, the PIF has become increasingly active, using the country's financial power to purchase stakes directly and indirectly.

KEY INVESTMENTS



The PIF became a major investor in Uber in June 2016. It has built up a nearly five per cent stake in Elon Musk's electronic automobile manufacturer, Tesla, worth roughly US\$2.5bln. The PIF has also agreed to put as much as US\$20bln into a Blackstone infrastructure investment fund.

In October 2016, the PIF provided US\$45bln to Masayoshi Son's US\$93bln Softbank Vision Fund, the largest private equity pool in the world. Part of the logic of the Vision Fund was for it to act as a front for the Kingdom, allowing it to increase its exposure to the technology sector while reducing the political implications of its investment. The majority of PIF's investment in the Vision Fund came in the form of 'preferred units', effectively bonds that guarantee an annual coupon of seven per cent. However, the PFI is also the second largest equity holder in the fund (behind the SoftBank Group).

In effect, the PIF was the vehicle to transform Saudi Arabia's low-risk-and-low-return liquid foreign assets into higher-return illiquid foreign assets. In order to do so, the PIF itself needs to transform its holdings of domestic companies into liquid assets that it can deploy abroad.

One-way the PIF will do so directly by raising money from abroad. In August 2018 it raised US\$11bln in syndicate loans. It will indirectly receive liquidity if and when PIF sell 70 per cent of Sabic to Aramco. However, the sale of Sabic could be delayed by difficulties in Aramco raising funds over the short term. Further loans to the PIF, or bond issuance, are also likely to be delayed.

These challenges could lead the PIF to slow its purchase of foreign assets. SoftBank is already facing a backlash over its relations with Saudi Arabia, with the company's stock price dropping around 15 per cent over the last month. SoftBank are also likely to delay, if not cancel, plans to create a Vision Fund II. Son did not attend 'Davos in the Desert' – a sign of the reputational damage caused to both SoftBank and Saudi Arabia by the Khashoggi affair.

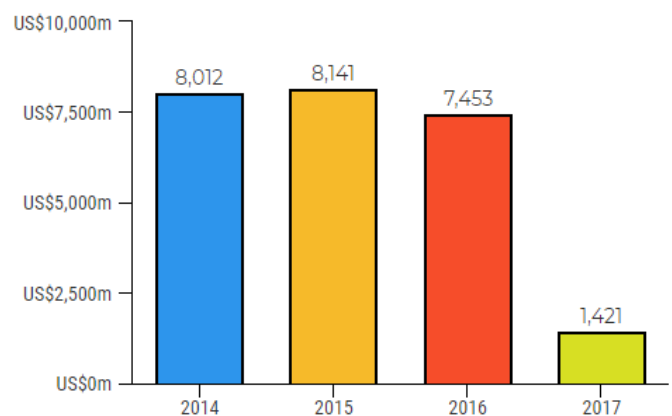
However, over the medium-term western institutions will continue to arrange funding for the PIF, and for the Kingdom. There may be some short-term reticent for firms selling equity stakes to the PIF, or associated funds, due to reputational and moral concerns - but given the sums of money involved this will likely blow over.

Investment into Saudi Arabia

The effect of Khashoggi's disappearance on inward investment into Saudi Arabia could be dramatic. MbS launched Vision 2030 to modernise the Saudi economy. The plan involved diversifying Saudi Arabia's domestic economy and increase employment for the Kingdom's 33m citizens.

The plan required buy-in from foreign investors. Infrastructure improvements and social reforms were part of a package to attract investment. The PIF has been a major investor in infrastructure, including in the huge Neom city project.

FDI Flows into Saudi Arabia



Source: UN World Investment Report 2018

Even before Khashoggi's murder foreign investment had fallen well below target. UN investment data shows that foreign investment fell to only US\$1.42bln in 2017, down from US\$7.45bln in 2016. The fall in FDI means that the Kingdom's share of total FDI inflows into West Asia was a mere 6 per cent of the total in 2017, down from 27 per cent in 2015, and 53 per cent in 2009. Saudi Arabia had targeted increasing foreign investment to US\$18.7bln by 2020.

Part of the explanation is austerity measures that have slowed growth, but investor confidence was also hit by the Crown Prince's anti-corruption drive, which involved the detention of several members of the elite.

Inward investment is likely to fall further. MbS's actions against political opponents, the blockade of Qatar, and the war in Yemen were partially ignored by the media and some of the global business community. The murder of Khashoggi will undermine the Kingdom's attempt to project itself as a modernising country. It also weakens the argument that MbS is an enlightened ruler.

Even if the Crown Prince was absolved of any responsibility, it would suggest a regime without sufficient internal controls to prevent its own officials from acting impulsively and against established international norms – a serious political risk for investors into the country. The overall effect could be profound.

In the interim, it is likely that the Saudi state will increase investment domestically. While state investment may help temporarily promote growth, a lack of major governance reform of Saudi public enterprises will create inefficient sectors, which will struggle to compete internationally. Such inefficient businesses can only be sustained by the Kingdom's continued injection of money into those sectors, thus increasing the Kingdom's reliance on hydrocarbon income.