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Saudi Arabia: The Next "Black Swan" For The Global Economy

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Just two weeks ago, the Saudi government announced that in September it will hit the international bond markets with a Dollar denominated issue. In the Kingdom's history, this is the first foreign debt issue. Incredible though it may appear, the sheiks, holders of the world's largest oil reserves, appear cash-starved. The Saudi monarchy that in 2011 was achieving an astounding fiscal *surplus* of 20% of GDP with zero public debt and sitting on over $700 billion of foreign reserves, has markedly seen its fortunes go into reverse since the oil price collapse in mid-2014. In 2015 the *surplus* morphed into a nasty *deficit* of up to 16% of GDP, public debt climbed to 10% while the currency reserves declined to below $ 600 billion. The Kingdom enacted even a few cuts in public expenditures, a measure unheard-of in the land of a guaranteed lifetime employment in the government sector.

In well-informed circles, the theory has been that the sudden decline in oil price was a deliberate strategy orchestrated by the Saudis, to kick the "shale oil" producers out of the market. Since the US producers rely heavily on debt and operate at loss when the oil price slips under $60 a barrel, such a plan could have worked. But it did not happen: with the Fed nailing interest rates around zero, the banks and the investment funds have continued to finance the drillers, who in turn have reduced production and cut costs. The result is that few drillers have effectively been pushed out of the market.

Now the Saudi strategy is backfiring and the big sharks of financial speculation are sharpening their teeth. The target is the fixed exchange rate between the Dollar and the Riyal (the Saudi currency). This monetary agreement between the two governments has lasted more than 30 years. The US economy and the Saudi elites have benefited immensely from it, with the latter accumulating sheer amounts of financial wealth.

The "Petrodollar" system worked in this way: US importers settled oil purchases only in Dollars at a stable, favorable exchange rate (by 1986 fixed at 0.26$ for 1 Riyal). In its turn, the Saudi Kingdom was committed to reinvest the profits in the US economy through the purchase of *Treasuries*, with the not negligible benefit of the guarantee of a continuous US military umbrella. All trades have been kept confidential for over 40 years till May 2016: neither the US nor the Kingdom has ever released detailed information about the involvement of the Saudis in the refinancing of US public debt.

In recent years, cracks have begun to surface in the apparently rock-solid deal. Thanks to the *shale oil* boom and the increasing market share of Iraqi and Iranian oil, the US is less dependent on the Saudis. The confidentiality shield has been lifted and finally the US Treasury revealed the amount of debt in the hands of the Kingdom: $120 billion, and it's reasonable to believe that at least a further $ 100 billion are discreetly held *offshore*. In the meantime, the US Senate has allowed the victims of 9/11 to sue the Saudi Kingdom for its eventual responsibility for the attacks. All these moves can be interpreted as a progressive cooling in the US-Saudi political relationship.

The numbers of this "twilight in the desert" can even appear healthy if compared with the troubled public finances of the major part of the Eurozone countries. At a rough estimate, the still gargantuan foreign reserves of the Saudi central bank would be enough to withstand a global speculative attack against the Riyal for up to more than 18 months, if the oil price remains stuck at 50$/barrel. However, it's not the outstanding amount of the reserves that really matters and the speculators are well aware of that. In fact, in order to defend the fixed exchange rate with the Dollar, the central bank needs to sell US *Treasuries* and buy Riyal denominated assets. This amounts to a restrictive monetary policy that reduces by definition the amount of money circulating in the economy and has substantial recessionary and deflationary effects. Moreover, the banking system can be badly affected by central bank policy through an increase in non-performing loans and in default rates. It's already happening: the monetary base and the banks' deposits have contracted for the first time under the threshold of $400 billion.

Not by chance, the markets are betting on an increase of public debt up to 50% of GDP in only 4 years and on a break-up of the fixed exchange rate. The markets' expectations can clearly be inferred by looking at the differential between the spot and the forward exchange rates at which traders settle their transactions on the derivative market. The probability of a Riyal devaluation within a year implied by the forward/spot rate differential hovers now around 25%.

If the oil price does not return to a stable, higher price (at least greater than 60$/barrel), the Saudi monarchy, already old and shaky, would not probably risk a rise in unemployment and social unrest. As already happened in China in August 2015, the monetary authorities would prefer to abandon the fixed exchange rate with the Dollar. The fall of the Petrodollar regime could potentially have an enormous impact on the global economy: the oil price would certainly fall to unprecedented low levels and emerging economies would be severely hit. A black swan lurking just around the corner.

The Eurozone would therefore suffer a further decline in foreign trade while the recession would gain ground in developing countries. Sure, the rock bottom price of oil would give some breathing space for consumers and manufacturing enterprises, but the net effect is likely to be deeply negative. Apart from these severe economic issues, the European markets would be shaken to their foundations by the collapse of another fixed exchange-rate regime. This does not bode well for the Euro's prospects as more than just a bunch of fixed exchange-rates but, as emerges from the Brexit drama, it is struggling to prove it.