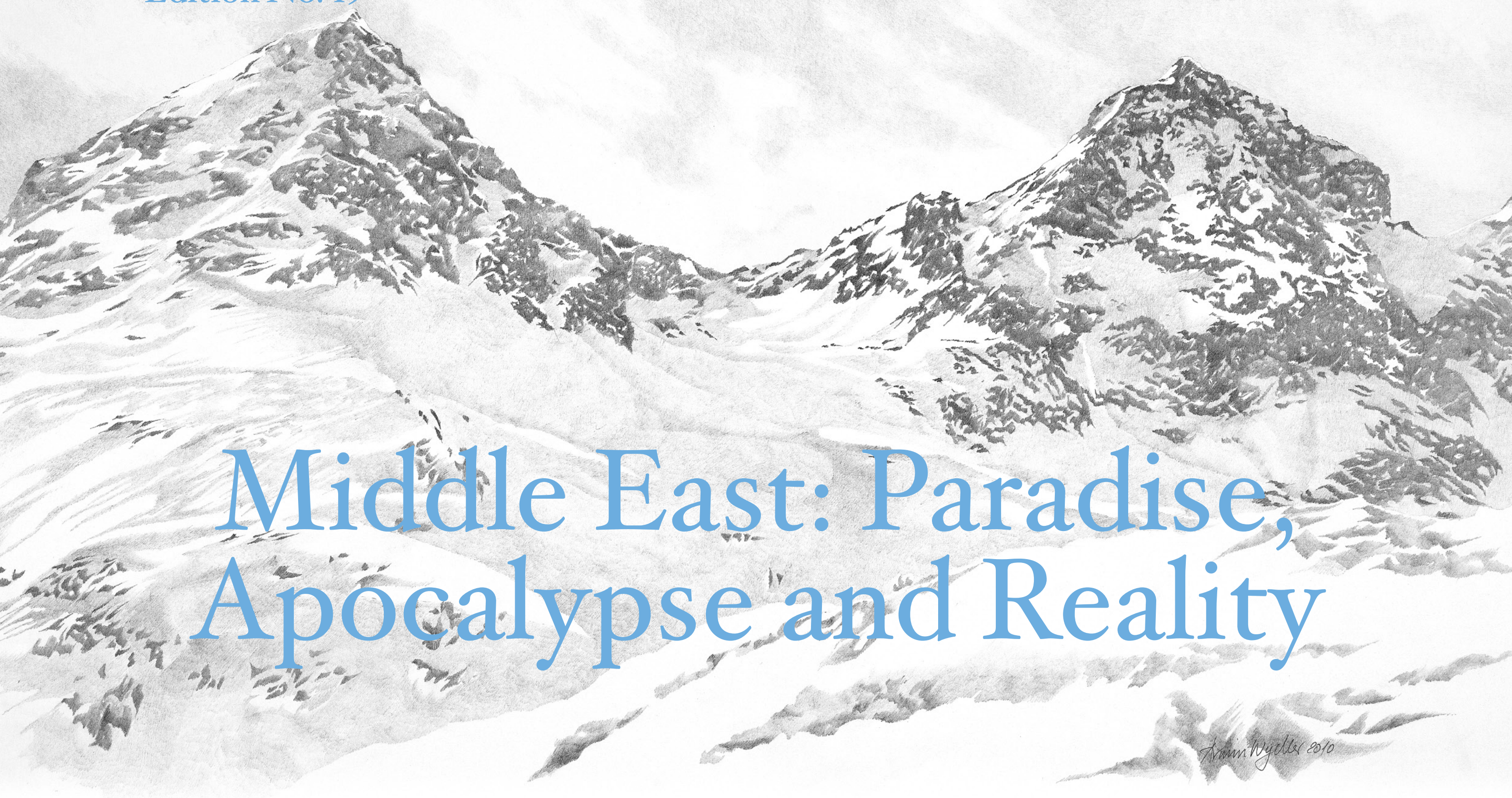


Middle East: Paradise, Apocalypse and Reality

bergsicht

CHAPTER 1

Like a hole in the head

While those with a hankering for jest, satire, irony and deeper meaning will certainly find rich pickings in contemporary German poetry and its fallout in Ankara, Berlin and Hamburg's regional court, the everyday experiences of long-distance travellers may offer similar, or even rarer, treats. Having boarded an A380, for example, and given a discreetly wide berth to the broiling conflict in Syria, where people are being slaughtered in droves and heads are routinely being smashed in or hacked off, you will soon find yourself touching down in what must be one of the most attractive, spotless and best organised airports in the world – Hamad International, in Doha. And what is the first thing you see in the panoptic main arrivals hall? The renowned sculpture by Urs Fischer, a Swiss-American artist, of a teddy bear with a desk lamp embedded in its skull. Tourists – especially the Chinese – queue up to take snaps of one another in front of the piece and, after making their obeisance before the ambivalent graven image to art, take their ease as they stroll through hectare after hectare of this earthly consumer paradise. The shocking simultaneity of real-world catastrophe and the artificial, hygienic, secure insularity with which it rubs shoulders will give the sceptical observer pause: which is more likely to last, the former or the latter?

Doha, Dubai, Abu Dhabi – there is no doubt that value has been, and is being, created here; the same was once also true of Baghdad, Damascus and Aleppo. The proximity of almost unparalleled prosperity and total disintegration is as disheartening as the realisation that, on the scale of global history, mere milliseconds stand between purported stability and the abomination of desolation. How fragile are the social conditions in which people are able to breathe free, do an honest day's work and enjoy the fruits of their greater or lesser fortunes? Is it possible for capital to be almost simultaneously (and more or less contiguously) accumulated and destroyed? How long can a world continue to function in which order and chaos are not only contemporaneous, but also perhaps co-existent? Are the waves of refugees washing up on the coastlines of Europe the dying fall of a geographically circumscribed conflict or harbingers of a wider, more protracted and escalating destabilisation? Will oil, the world economy's lifeblood, a good quarter of which is supplied by this region, continue to flow so freely? Will the wells run dry, or might oil producers, driven to the edge of a political precipice, even turn the tables and flood the globe with crude out of sheer desperation, thus strangling at birth any hope of a global energy revolution?

These and similarly insistent questions will continue to vex the attentive world traveller to such an extent that he may even begin to perceive another, deeper meaning in the hapless and – in a culture so averse to representational art – strangely incongruous teddy bear. In this edition of *bergsicht*, we wish to share questions and thoughts about this region of the world with our readers; to analyse and contextualise while using scenarios to model the area's future and its possible contribution to international order and the global economy. For belt and braces, we should nonetheless mention at the beginning of this essay that we are obviously dealing with imponderables and future circumstances may yet take on a very different guise.

CHAPTER 2

Complex geography

The first step in any such assessment is to define our terms and check our bearings. "Middle East" is an imprecise term. German distinguishes between the "Near East" (*Naher Osten*) and the "Middle East" (*Mittlerer Osten*), which extends beyond the Indian subcontinent; in English, the "Middle East" is more or less coterminous with the German notion of the Near East. Our understanding of "Middle East" in the following encompasses the extended environs of Mesopotamia – the land once supposed by some (and still supposed by others) to hold the Garden of Eden.

History has been written on this spot since the Fall of Man. It was here that the Sumerians invented cuneiform writing, Hammurabi set down law in writing and major world religions first saw the light of day. It is where high culture once held sway and the cradle of civilisation stood, but no power base has since managed to establish itself here over the last 2,000 years. By the year 750 CE, the Caliphate extended from Hindustan in the East to Andalusia in the West, with its centres at Mecca and Medina on the Arabian Peninsula. Prior to this, the expansion of Persian power, in a panoply of forms throughout modern-day Iran and far further afield, had lasted for centuries and left a significant cultural legacy. When we speak of the "Middle East" as a trouble spot in the modern world, it is not entirely without merit to be thinking of it in terms of the *tectonic fault line* between Persia and the Arabic centre of the Caliphate and/or the overlap between these two empires. External constructs have been overlaid along this fault line and across this area of overlap on two occasions in history: in the first instance, i.e. from the close of the Middle Ages to the end of the 19th century, by the Ottoman Empire (which had its nerve centre in Istanbul), and subsequently by the European colonial powers of Great Britain and France, which traced a border that more or less still stands today ("Sykes-Picot", named after the English and French delegates who carved up the remains of the Ottoman Empire between them in 1916), creating an arrangement of states that rides roughshod over tribal, ethnic and religious considerations.

From a global geographic perspective, the Middle East lies at a crossroads between north and south and between east and west; gigantic airports such as Dubai or Doha, mentioned above, are testament to the necessity of changing planes in order to travel on in one direction or another. Anyone flying from Europe to Southeast Asia is likely to have a layover here, and the same is true if your final destination is East Africa. As with air traffic, so with the flow of goods across the world's oceans, not least thanks to the Suez Canal, which substantially shortens East-West passages. If Chinese plans to resurrect the Silk Road materialise, the Persian Gulf will be more crucial still, thanks to the already largely completed port of Gwadar on the western fringes of Pakistan and the high-capacity roads to be built over the next few years, which are to run down from Western China and through the Karakoram before crossing Pakistan *en route* to the sea.

In some ways, the Middle East is land that has been blessed; nowhere else on Earth will you find such an abundance of high-quality crude oil. The average cost price for extracting it is correspondingly low – a state of affairs to which we shall return in our analysis of the oil trade. For the states defined by the Sykes-Picot Agreement, the specific geographic distribution of oil deposits in the ground has meant that some countries have come away empty-handed while others are left swimming in surplus, unless of course they have succumbed to the undertow of unrest (Iraq) or hitherto been excluded from world trade (Iran).

Approximately 250 million people live in the Middle East. Some scrape along close to or even below the poverty line while others are as rich as Croesus. The Middle East has more migrant workers than virtually any other part of the world. Centres such as Riyadh, Dubai, Qatar or Kuwait are largely run by expats; the indigenous population essentially hire and fire staff to wait on them, and pay with petrodollars. This migrant workforce (to all intents and purpose a class of slave labourers) provides its – generally dirt poor – home countries such as Pakistan or Bangladesh with a welcome infusion of foreign exchange in the form of remittances to relatives. A mobile workforce is part and parcel of the economic and social model in the Middle East, but in addition to this *labour migration*, mention must be made of the *unemployment* that is increasingly rife across large reaches of the Middle East, and the low productivity endemic beyond the isolated "special development zones". About a million young people come out of the traps in Egypt every year, entirely fit for work but with very little prospect of employment. Militias of every stripe swell their ranks from this unfortunate demographic morass and the millions of young people debased by life in such fighting forces have precious little hope of ever being able to hold down a regular job.

The religious geography of this region is particularly complicated, and the traditional differentiation between Sunni and Shia Islam is too simplistic; there are sects and factions on both – diametrically opposed – sides that are difficult to fathom, with membership often running along lines of kinship. Areas of concentration are nonetheless identifiable, however. The majority of Shi'ites live in Iran, central Afghanistan, Bahrain and South Yemen, while areas that are fairly uniformly Sunni include Saudi Arabia (although with a significant Shi'ite minority in the oil-rich east of the country), parts of Afghanistan and Pakistan, and Turkey; dangerously mixed zones have coalesced in Iraq, Syria and Lebanon. A distinction should be drawn between this denominational delineation and any ethnic taxonomy: Pakistani and Persian natives have Indo-Germanic roots, and are thus distinct from the Arabs and all those descended from the Turks, who form a *bloc* against Europe to the west and Russia to the north.

CHAPTER 3

Exports and externalities

The Middle East is undoubtedly crucial to the global economy and to the world as a political system. We have already mentioned the high proportion of crude oil originating from this region, and the country of greatest consequence here is Saudi Arabia, the world's leading supplier of this valuable commodity. It currently produces about 12.9% of global output, followed by Russia (12.7%) and the USA (12.3%). Incidentally, Saudi Arabia is also a major end user of crude, accounting for almost 3% of global consumption. This is a result of both the country's Herculean efforts to make the Arabian Desert vaguely habitable for its population of approximately 30 million souls and its attempts to reduce its dependency on imported strategic goods. One might also be tempted to call it improvident squandering... The most important customers who are strategically reliant on oil from the Middle East are China (12.4% of global consumption), Japan (4.7%) and India (just shy of 4.3%).

The major crude oil producers – Saudi Arabia, the United Arab Emirates and especially the smaller countries, such as Qatar and Kuwait – are economically and socio-politically highly *dependent on the oil trade*. They have tried every trick in the book to correct this imbalance, from inveigling service providers and industrial companies (with all the investment that accompanies them) into settling there, to hosting the football World Cup, but the bottom lines of all these countries' economies tell the same unmistakable tale: nothing happens without oil. Essentially, fossil fuel is exported and the receipts are either consumed and invested or offset via the capital account. Domestic consumption is effected by means of an ingenious and broadly stabilising system of patronage: in Saudi Arabia, some 2,000 princelings are first in line at the trough for oil revenues; the "non-jobs" retained for them and their large retinues of direct beneficiaries ensure loyalty to the royal House of Saud, which naturally will last only as long as the oil flows. Generating cash flow to maintain an altogether prodigal lifestyle – such is the nature of this feudal society, and simultaneously also its Achilles heel.

Capital account: this simple term designating the net change in asset ownership for a nation is pertinent to a less well appreciated but crucial function of the rich, oil-exporting countries of the Middle East. Saudi Arabia holds some USD 600 billion in foreign securities, USD 116.8 billion of which are currently (March 2016) US Treasuries; some of these assets are managed by sovereign wealth funds. The oil states (including Norway, by the way) have been carrying out, and continue to carry out, a kind of *asset swap* for that portion of the oil revenues which is not consumed or invested domestically – transmuting black gold into real gold, as it were – to create a more diversified portfolio. As enormously powerful global market participants, they have more clout than many central banks. In certain respects, their role amounts – *nolens volens*, and wittingly or unwittingly – to that of creditor of last resort. This can have a stabilising effect – many a Western financial institution would likely have gone under during the 2008 crisis without support from the Middle East, not least Credit Suisse, which was spared the humiliation of having to go cap in hand to the Swiss government thanks to a capital injection of almost CHF 10 billion from Qatar's sovereign wealth fund. However, the capital exposure of oil-exporting countries also has the potential to destabilise, as it represents a *cluster risk* for the fragile finances of Western debtors – viz. when the creditors are no longer willing or able. Saudi Arabia's recent bid to raise USD 10 billion in a sovereign bond issue – for the first time since 1991 – has made observers sit up and take notice; somehow, the cash no longer seems to be flowing as it should.

The term "consumption" for the spending habits of the Middle East's oil-producing countries doesn't quite hit the nail on the head, however; not all the money is blown on luxury cars and yachts. A considerable amount is also deployed in the form of genuine capital expenditure. The smaller or slightly poorer Gulf states in particular (especially Oman, with its highly cultivated ruler) have for many years been at pains to diversify away from oil and – a more difficult task by far – to entice their countrymen into doing a spot of productive work. We had the opportunity to witness an "Omanisation programme" up close. When all's said and done, little is generally achieved with these quota systems or top-down work education programmes; the few expats still retaining a work permit in a firm just have to work twice or three times as hard as before, while the home nationals on the staff sport cheery smiles but are largely passive and can rarely be sanctioned at work, let alone sacked. This type of regulation merely erodes the productivity – and hence profitability – of such companies.

Where greater liberality obtains on the labour market, and this includes in particular the "free zones" of the Gulf states, capital expenditure falls on far more fertile ground. Virtually all large Western industrial companies now maintain a representative office, if not a manufacturing facility, in the United Arab Emirates. The central location, highly efficient infrastructure and minimal – or non-existent – taxation make such investment decisions all the easier. The risk of such ultimately insular conditions being destabilised cannot be dismissed out of hand, of course, but everything is relative – by comparison with Sudan, Eritrea, Somalia and even Egypt, this is a region of nigh-on heavenly stability! And what is more, if the return generated within a reasonable period is sufficiently high, a risk that may lurk in the medium or long term is of little concern. We may conclude that there are plenty of Western industrial and/or export nations – including Germany and Switzerland in particular – whose economies would be in a far sorrier state were it not for the demand for equipment and machinery emanating from this corner of the world. Oh, and then there are the arms sales…

Unfortunately, the Middle East does not limit itself to exporting oil and importing consumer and capital goods (not to mention Western securities); it has for decades been the wellspring of *international terrorism* and, increasingly, of a jihadism that disdains all other manners and mores. In addition, the region has for some years (i.e. since the dissolution of Gaddafi's Libya and the outbreak of the conflict in Syria) been sending forth a flood of *refugees and migrants* – towards Europe. The disparity in security and affluence has unleashed a veritable exodus, but insular prosperity and chaotic destruction nonetheless continue to co-exist in the face of international terrorism and this tide of emigration. Reports of attacks in the Emirates or in Saudi Arabia are distinctly thin on the ground, and there is not a chance of neighbouring states taking in Syrian refugees – in the immense, air-conditioned tent cities of Mecca, for example.

For the purposes of our assessment, the key question is: to what extent will the "exports" and externalities mentioned here change in light of the scenarios we are about to elaborate? The answer to this question is likely to have a considerable bearing on the future course of the global economy and our shared existence on this planet.

CHAPTER 4

The dangerous end of a hegemony

As the colonial powers ceded their ascendancy in the wake of World War II, the countries sketched out by Sykes-Picot attained real autonomy; for those that were not already traditionally established as kingdoms or sultanates, this sovereignty generally took the form of autocratic rule. Notwithstanding the occasional regime change (protractedly so in the case of Egypt, for example), relative peace reigned across broad swathes of the Middle East until the fall of Saddam Hussein at the end of the second Gulf War. After the bloody toll of the war against Iraq during the first Gulf War and as a result of its opaque nuclear policy, Iran had taken itself out of circulation, so to speak, and was consequently only able to act covertly (Hezbollah). Thanks to American patronage, *Saudi Arabia*, Tehran's nemesis, had *the upper hand* during this period. That this patronage would ever play second fiddle to Israel's unconditional right to American protection was acknowledged as one of the stabilising rules of the game and was thus always accepted by the Saudis.

These stabilising rules came to an end with the USA's military and political setbacks in Afghanistan and Iraq in particular and the ideologically blinkered support afforded during the supposed democratisation in the aftermath of the Arab Spring. The seeds of violence had already been sown in the form of support and consignments of arms from the Americans (and, by proxy, the Saudis) to so-called freedom fighters. A number of autocratic – and, to Western eyes, highly problematic – regimes were swept away by the Arab Spring uprisings. To what end? After years of bloodletting, we are now faced with entities that are generally less stable, more autocratic and less balanced in terms of their ethnic and religious fabric, while conditions akin to civil war prevail from Tunisia (where there is still some hope) through Libya, Egypt and Syria as far as Yemen. Chaotic and complex circumstances with any amount of potential for escalation – ticking time bombs – have become the norm.

The West acknowledged the twin failures of military *and* political defeat in the region only reluctantly, by moving to integrate – and reset its diplomatic relationship with – Iran; unsurprisingly, the House of Saud, too, has been distinctly reluctant to accept that it is no longer top dog. The Saudi royal family is caught in a *perfect storm*. For a start, it has had to come to terms with a painful loss of relative importance through the rise of Iran as a respected regional power, and for a jurisdiction that perceives itself as the ultimate and absolute protector of the holy shrines of Mecca and Medina, this is a bitter pill to swallow. Second, the cash flow from oil receipts is threatening to dry up, while a population that has increased ten-fold from 3 million to about 30 million between 1950 and 2016 needs to be fed. Third, by proclaiming the Caliphate, the bastard, banished scion of the family that is the so-called Islamic State (IS) has cast doubt on Saudi Arabia's claim to hegemony in the region. Fourth, with the most recent succession having been completed only recently (2015), the next is already looming, as King Salman ibn Abd al-Asiz is suffering from advancing dementia. Fifth, the question of the pecking order within the royal family is yet to be settled: although Crown Prince and Minister of Interior Muhammad bin Nayef is chief of police, chair of the council for security affairs and director of the intelligence services, the real power behind the throne is the more dynamic Prince (and Deputy Crown Prince) *cum* defence minister, Muhammad bin Salman, who controls the army.

A schism within the royal household can thus not be ruled out. Sixth, the military campaign in Yemen is proving an unremitting catastrophe, mercilessly laying bare the shortcomings of a Saudi army that, while armed to the teeth, is desperately undermanned: too many chiefs, and not enough battle-hardened Indians with stomach for the fight. In summary, a turnaround will not be possible without domestic reform – but religious zeal (a seventh complication!) prevents hardline Wahhabis, the traditional power base of the House of Saud, from being able to countenance any such action.

Muhammad bin Salman is already trying to get ahead of the curve. "Vision 2030", a study commissioned from McKinsey, is intended to usher in a comprehensive restructuring of the nation and its social contract. The plan consists of six core goals: part-privatising Aramco, the state oil company, with the profits to be diversified into non-oil undertakings; opening up the country for tourism and land ownership by residents of foreign birth; cancelling subsidies for oil, gas, electricity and water; promoting small and medium-sized enterprises and simultaneously reducing unemployment to 7% (suggesting it is a good deal higher at the moment); developing a high value-added industrial sector that will include petrochemicals; and tackling corruption in the defence sector (implying there is no shortage of such problems at present) while building up the domestic arms industry.

Paper is patient, and costly PowerPoint presentations are doubly so. Doubts that such a programme, handed down from on high, will even begin to have the desired effect are certainly warranted. We feel sure that Saudi Arabia will be a country at risk over the coming years, and this may not only decisively alter the balance of power in the region but also entail painful consequences for the world order and the global economy as a whole.

CHAPTER 5

Relativising an important price

The relationship between the world economy and the oil supply and/or price has been existentially strained ever since petroleum's irresistible rise as the most practical of all energy sources. Furthermore, fossil fuels have a say in the make-up of the world's power structures that goes beyond even supply and demand: the colonial powers prosecuted wars for it, American presidents have leapfrogged into office on the back of it, our neighbours to the East are trying to use pipelines to steer Europe towards their way of thinking, and the People's Republic of China, which was right at the back of the queue when they were handing out oil deposits, is building a gigantic maritime strike force to ensure strategic supplies of the precious black liquid.

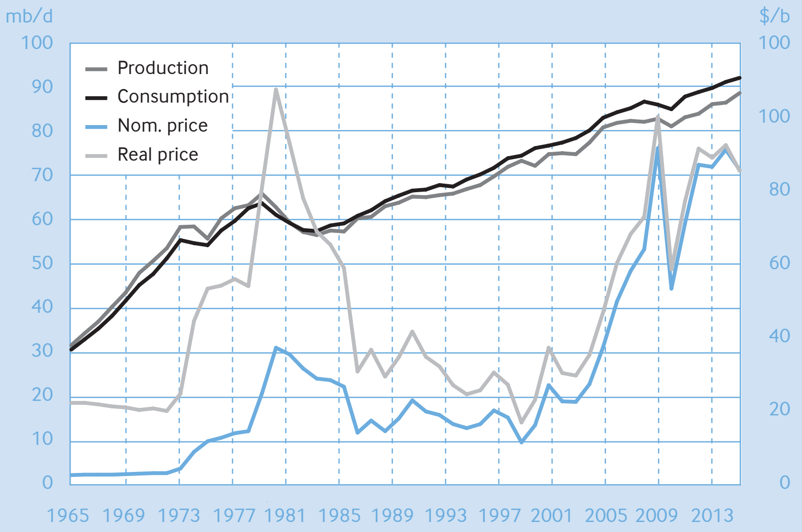
Correspondingly, oil is handled with kid gloves on the markets. Who really cares if iron ore, wheat, coffee or cocoa bean prices wobble? At best a little covey of those directly involved. But when oil sneezes, there's not a market participant that doesn't feel the cold; indeed, in certain circumstances, there may be a collective shiver. However, a glance at a few relevant bits of data would lead one to suspect that this panic inherent in the market is hugely exaggerated and in some respects yesterday's news. In the chart below, we have mapped the various price fluctuations onto a representation of the world's actual supply of oil over the last 50 years. The following observations are noteworthy:

- Supply and demand for crude, measured in barrels per day, are astonishingly *constant* over the whole period; there is no question of any genuine bottlenecks in supply. The industry has clearly had no trouble taking exogenous shocks such as wars (Vietnam War, Gulf Wars) or paradigm shifts in global history (China's entry into the global economy, collapse of the Eastern Bloc) in its stride.

- Given these production and consumption figures, there is little to support the fear (or hope, depending on political persuasion) touted throughout the entire period that supplies of crude oil might run dry.

- While consumption of crude oil has increased in absolute terms and will continue to do so,

Oil production, consumption and price



Source: Bloomberg, Timo Grossenbacher (2014).

when measured against the growth in the world economy over this period, a clearly decreasing correlation – and thus a fundamentally lower dependency of global GDP on oil – is discernible. Crude might yet be on its way to becoming a *conventional commodity.*

- What does fluctuate extraordinarily violently, however, especially when viewed against this uniformity of real output and consumption, is the price of oil. Just imagine if another factor price in the economy – labour or the cost of capital, for example – were to seesaw to this extent! The absorptive capacity of the global economic system for very high and very low crude prices is nothing short of fascinating.

We see the price of oil as very closely mimicking the trajectory of the financial markets – which are largely decoupled from the workings of real economic production and feature high volatility, abrupt corrections, excessively frequent extreme risk events and "irrationality", while the output of the real economy in most countries and in the world as a whole ploughs a fairly constant furrow. Historically, this has not always been the case. Fluctuations in GDP of +/- 10% were not uncommon right up to the end of the 19th century. We submit that it is practically the point and the essence of the markets, driven as they are by financial expectations and "speculation", to smooth the output of the real economy with their wild swings; most observers see this interdependence exactly the other way around, however: "evil" markets, they contend, disrupt real economic conditions.

Be that as it may, the price of crude – irrespective of the overarching absorptive capacity of the global economy – is clearly of enormous economic significance for both the supply and demand side, as well as for all those trader-middlemen arrayed between them. To describe this significance in detail would be beyond the scope of this *bergsicht* – the cyclicality of periodic over- and undersupply observable on the crude market and the associated alternation of "backwardation" and "contango" (i.e. the way forward prices undershoot or overshoot spot prices) could fill volumes on its own, as indeed it does. A *tour d'horizon* of the literature suggests that conditions are highly complex, and we have been unable to identify any model with genuine prognostic capabilities that is valid over the longer term. One thing you can say is that it generally – but not always – pays to have stocks of crude tucked away in a fuel depot or the like. At the moment it emphatically does not, which is why supplies built up using substantial leverage have morphed into a major risk for debtors and their creditors (not to mention a banking system that is already under pressure...).

Of considerably more interest to our assessment of the state of play in the Middle East is the connection between the average full cost price, the marginal production price and the implicit price of crude – the latter being the price required to cover all the costs of the *contrat social* in Saudi Arabia and the Gulf states we have outlined. Let us take the *full cost price* first: as a result of regional geological conditions and the associated nominal investment costs, this is incredibly low for such a high-quality product; it is only a mild exaggeration to say that a digger simply has to scratch the Earth's surface and out it gushes. While the story is not quite as simple as this, there is certainly a world of difference between local procedure and the far more laborious and investment-intensive prospecting techniques required elsewhere, which are also more problematic from an emissions perspective; a price of at least USD 70 per barrel is anticipated for oil derived from "fracking" (i.e. extracted from oil shale), while the average full cost price in the Gulf region is likely to be somewhere between USD 10 and USD 20 per barrel. From a commercial point of view, such a price cannot be undercut over the long term as bankruptcy would soon threaten and/or new investments prove impossible. In the medium term, both cases result in hiccups in production and loss of market share.

In the short term, however, an item can of course be taken to market at *marginal cost* – or even below this level if existing reserves are brought into play. Marginal costs are calculated on the basis of the variable expenditure required to produce a specific additional unit of any item. Anyone with low marginal costs and a ready supply of product to hand will have *market power* and be able to force his competitors into a corner – and thus largely determine prices, especially when demand is "stiff" (what economists call "inelastic"). This means that, whatever the price, consumers are scarcely able to switch to a replacement product, and certainly not at short notice. Saudi Arabia, the *primus inter pares* of the cartel of OPEC states, has always pulled out every stop to exploit this inherent market power. In any cartel, the members will fundamentally tend towards undercutting the tariffs agreed; by dint of its rock-bottom full costs and still lower marginal costs (combined with more or less unlimited stocks of oil in the ground), Saudi Arabia has repeatedly succeeded in restoring discipline to the ranks.

In the meantime, a third variable has increasingly been putting the kibosh on this situation and sapping Saudi Arabia's market power from within: the *implicit price*, that is to say, the price required to prop up the social contract described (i.e. to satiate 2,000 voracious princes while putting food on the tables of 30 million inhabitants). Estimates for this fiscally calculated *structural variable* differ, but something approaching USD 80 per barrel would probably not be too far north of the mark. If the global market price of oil drops below this, Saudi's rulers have to dip into the state coffers to continue honouring their obligations. When these state coffers run dry, assets have to be sold to refill the piggybank. If push comes to shove, out-of-pocket expenses have to be financed with a trip to the capital markets, and this is exactly the scenario that has been unfolding since prices fell off a cliff 18 months ago, from over USD 100/barrel to periodically less than USD 30/barrel. In short, the House of Saud is on the horns of a dilemma: global market prices approaching full cost, indeed up to marginal cost, would be required to instil discipline within the cartel; to take the sting out of their own financial situation, however, prices would have to be nudging USD 100.

This quandary is compounded by the fact that the *inelasticity* of demand is also no longer what it once was; the trials and tribulations experienced over the last decades by industrial nations that are less well-supplied with oil, combined with environmentally driven efforts, have resulted in a greatly enhanced capacity for finding oil substitutes; nowadays, it is quite possible to manufacture fuel for cars from coal or biomass, and the electric car is just round the corner. Geothermal, solar and wind power are making substantial contributions to the energy mix in developed countries and, bearing in mind the 32 nuclear power plants in China, for example (which are set to be joined by a further 20 over the next few years), atomic power is anything but a busted flush. The oil-producing countries are no longer going to have such an easy ride when it comes to ratcheting up the price of black gold – anything but. We anticipate that overcapacity created by the investment boom, and thus deflationary tendencies, will predominate – just as elsewhere in the economic system. This is a gloomy prospect for countries that are highly dependent on oil revenues. They will be left facing a challenge to which they are historically unaccustomed and with which they may be unable to cope: that of rapidly emptying coffers and treasuries.

CHAPTER 6

Three scenarios

Working from the "perfect storm" we have described bearing down on the Saudi royal family (and indeed on the other Gulf states as well), the highly complex military conflict in Iraq and Syria which still awaits any real de-escalation, and the re-emergence of Iran in the matrix of powers within the region, we have identified three scenarios to envision future developments in the Middle East. The first is realistic and depressing, the second realistic and a little more hopeful, and the third we may unfortunately presume to be fairly far-fetched.

- The flashpoint in and around Syria does not peter out but instead gradually spreads into the neighbouring countries and beyond. In shifting coalitions, the external forces of the USA, Russia, core European powers, Turkey, Iran, Saudi Arabia and, indirectly – via its new ally, Pakistan – even China attempt to influence events to their own advantage. The disappearance of Saudi Arabia's nuclear reinsurance courtesy of Pakistan results in a temporary ascendancy for Iran that is unacceptable to Israel. Turkey flits between the power blocs, repeatedly holding the Europeans hostage. Saudi Arabia begins to crumble and itself becomes a trouble spot. New floods of refugees are unleashed. Oil production and – increasingly – oil prices follow the vagaries of the course of the war. Once-proud insular centres of prosperity such as Dubai are laid waste and ruled by extremists. A fight for power, influence and territory, for tribal, religious and ethnic gain ensues without ever reaching any real conclusion. Only the next – war-weary – generation will be in any mood to put an end to this miserable sport. Ultimately, a series of new countries as yet unknown to us will be created. We call this scenario the "Thirty Years' War".
- In response to multiple egregious acts of aggression against soft targets within the Western civilised world, the major external powers resolve to take up arms against the so-called Islamic State (IS); the enterprise meets with success. The involuntary coalition thereby called into existence lays the foundations for implicit equilibrium and the real-world, cheek-by-jowl co-existence of highly disparate powers. An externally imposed, tacit rule of non-intervention in the various spheres of interest prevails, on the back of which new borders are effectively drawn and nations built. All that emerges in many areas are feudal mafia states, and institutional order is maintained only as a fig leaf for the benefit of Western donors; such a borderline tolerable regime has persisted for a good while in Lebanon, for instance. Real, externally imposed co-existence will thus be the norm in the Middle East for a considerable period of time. We have dubbed this scenario "Ordered Disorder"; while permitting of growth and prosperity, indeed of a certain release from oil dependency, life in this scenario would be desperately precarious.
- Starting from Turkey, the sentiments of political Islam gain dominance and gradually oust the political structures of autocratic countries; a separate group of countries in the Middle East inclines towards the Iranian model – a blend of democracy and theocracy. The West comes to terms with the normative power of the *de facto* position as far as governance is concerned and favours relative non-intervention in this region of the world. Iran is able to flourish and assert its existence as a responsible actor and recognised regional power. Given the ongoing stalemate between Saudi Arabia and Iran, a four-way power equilibrium is likely to arise over time, encompassing these two regional powers, Turkey and (implicitly) Israel. The Middle East becomes a more or less "unremarkable" region of the world, keeping itself in check under its own steam and thus giving good reason for hope and, further down the line, prosperity. Given the nexus of interests, let us call this internally sustained – and actually rather obvious – scenario "Balance of Power".

Hybrid scenarios are clearly equally conceivable, as is a fourth possibility in which a new hegemonic authority emerges to supplant the ineffectual USA. But who on Earth would have the power to create order down there on their own?

CHAPTER 7

So what?

As far as the consequences of these scenarios are concerned, at this juncture we will focus on just three; much more of course could be said (or indeed surmised). Self-evidently, more or less open warfare in such a manifestly troubled region of the world would be enormously damaging to the general growth and good fortune of the global economy. War most directly destroys assets, but it also destroys hopes and expectations in particular, namely those of the generations to come. The "Thirty Years' War" scenario would be largely catastrophic for the rest of the world – unless you happened to be an arms manufacturer – and any less harmful outcome would be relatively auspicious by comparison.

First: as regards *supplying* the world with *oil* (which will certainly remain extremely important), continuation or proliferation of the military conflict would undoubtedly further amplify the volatility of oil prices, rendering the capacity to stockpile and reliably supply crude a more profitable proposition while also tending to accelerate the switch to alternative energy sources. By the same token, we could definitely envisage in the case of the more moderate scenarios a gradual and partial distancing of the global economy from its unilateral dependency on oil; we are therefore loath to entirely dismiss the Saudis' "Vision 2030" plan as pure fantasy. The megatrend whereby oil becomes a standard commodity has long been written in the stars; it is exactly the same trajectory followed by spices (which used to change hands for sky-high prices and over which wars were also once fought) and cooking salt, which was famously responsible for starting the French Revolution. Predicting a "reasonable" price is to give hostages to fortune, but we believe that a full cost price of about USD 60-80/barrel for fracking oil would not be too implausible in such a scenario.

Prolongation of the military conflict in the Middle East over the long term, and in particular its propagation towards the West – that is, through Egypt and out into the Maghreb – would create an extraordinary challenge for Europe, to put it mildly, as (secondly) it would result in endless, barely controllable *surges of migrants* from Africa and the destabilised zone in Asia, with *apartheid*-like structures ultimately likely to take root in European societies. Capacity to absorb migration ends with the sheer numbers of immigrants and their cultural, ethnic and religious diversity, and we fear for the cohesion, openness and liberality of the nations of Europe. If events in the Middle East take a generally more orderly turn, it is not difficult to imagine a constructive role for Europe in this corner of the world, indeed even in the Maghreb – a region that has long had a vibrant intellectual exchange with the Old Continent. Tacit acceptance of forms of governance other than those practised in Westminster and the German *Bundestag* coupled with abnegation of the trappings of post-colonialism can certainly lay solid foundations for synergetic prosperity – and this applies in particular to the Europe's relationship with Turkey.

Thirdly, all these points have one thing in common: the *capital overhang* from the Middle East will in all likelihood go into reverse – indeed, it may already have done so. In all three scenarios, oil production and/or the price of oil will no longer be sufficient to cover structural costs – neither for the protracted and dogged prosecution of a war nor yet for the capital-intensive remodelling of the societies concerned. This will have repercussions on the global financial markets. The steady demand for equity investments from the major sovereign wealth funds is just as likely to become history as reliable purchases of Treasury bills to balance the region's current and capital accounts. The financial markets and the creatures of habit that trade there have come to rely all too heavily on the deep pockets of the Middle East in recent decades. If the Chinese turn inwards to focus on their domestic market, appetite for investment from that quarter will taper off. Should the Middle East find itself selling less and less oil – at increasingly lower prices – or if oil revenues are eaten up by expensive wars, demand shifts will inevitably follow on the financial markets. We have sought long and hard for trigger points that might prompt an interest-rate hike in the West. We may just have found one.

KH, 23 May 2016

Translated by: Richard Hall (www.motif.ch)

M1 AG
P.O. Box 344, Museumstr. 1
9004 St. Gallen – Switzerland
Phone +41 (0) 71 242 16 16
Telefax +41 (0) 71 242 16 17
info@m1ag.ch

Subscribe: www.bergsicht.ch