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State of Kuwait: Country Risk Insights

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In a nutshell

- Kuwait, one of the world's richest countries, has a financially stable economic system that is supported by large oil reserves. Real gross domestic product (GDP) growth in 2014 fell to a post-Global Financial Crisis (GFC) low of 0% from 1.0% in 2013, partly on account of the oil price collapse during the year. Falling oil production in 2H2014 due to the closure of a neutral zone oilfield, as well as moderating activity in the non-oil sector also contributed to slower growth. Notwithstanding the fall in growth pace from the post-GFC high of 10.6% in 2011, the economic system remains financially stable. The International Monetary Fund (IMF) expects growth in 2015 to rebound slightly to +0.3% and to improve further to +2.4% in the following year. The government has considerable financial buffers to cushion some of the growth impact from lower oil prices.

- Due to the monetisation of considerable oil reserves, Kuwait has a strong fiscal position even though its fiscal performance has been weakening, especially with the collapse of oil prices. As a result of high average fiscal surpluses generated over the years, it has a large fiscal buffer. The Kuwait Investment Authority (KIA), Kuwait's sovereign wealth fund, manages assets worth more than USD590 billion, equivalent to about 326% of GDP and more than 700% of total government expenditure. In addition, total government gross debt is very low, standing at just 3.2% of GDP as at end-March 2015.

- Kuwait's external payments position also remains strong because of large external buffers, thanks to large current account (CA) surpluses generated over the years. At end-2014, its international reserve assets stood at USD32.3 billion, enough to cover 7.6 months of imports of goods and services. Meanwhile, the USD590 billion worth of assets managed by the KIA also form a significant buffer to external shocks. As expected, Kuwait is a creditor nation, as indicated by its strong net international investment position (NIIP), which at end-2013 stood at USD116.5 billion.

- Notwithstanding the substantial benefits the oil sector has brought the economy, Kuwait's overdependence on volatile oil exports has become a source of increasing risk. It has resulted in volatile economic growth. It has also led to large public sector employment, crowding out of the non-oil tradeable sector and declining productivity. Kuwait's growth model is also becoming increasingly unsustainable because of lower oil prices. Its fiscal performance going forward has become a critical concern. In fiscal year (FY) 2014/15, the fiscal surplus fell to 17.4% of GDP from its post-GFC high of 36.1% (FY2011/12). After mandatory transfers to the Future Generations Fund and excluding investment income, the fiscal balance fell to a deficit of 4.4%. And while Kuwait's external payments performance remains strong, its CA surplus has fallen somewhat. In 2014, it fell to 31.2% of GDP from the post-GFC high of 45.2% (2012) due in part to the oil price collapse. While Kuwait's external payments performance and position are unlikely to become an issue over the short to medium term, economic diversification has to start now because the process takes time.

- While Kuwait risks social unrest if its attempts at economic diversification to strengthen growth potential and create jobs are unsuccessful, poor governance and slow pace of reforms are hampering such efforts. Weak governance and institutions have resulted in the sluggish implementation of public investment priority projects, and this is a major downside worry. Besides being lowly ranked in the World Bank's Worldwide Governance Indicators (WGI) project, it is also lowly ranked in the World Bank's Ease of Doing Business 2015 report. Kuwait needs to strengthen its growth potential very badly. However, it would need to improve governance and institutions first.

Table 1: Selected economic indicators

	2009	2010	2011	2012	2013pl	2014pr
Real GDP (% y-o-y; at factor cost)	-7.1	-2.4	10.6	7.7	1.0	0.0
CPI inflation (% y-o-y; period average)	4.0	4.0	4.9	3.2	2.7	2.9
Fiscal balance (% GDP)*	28.9	23.8	36.1	31.7	34.8	17.4
Total gross public debt (% GDP; calendar year-end)**	6.7	6.2	4.6	3.6	3.1	3.2
Current account balance (% GDP)	26.7	31.8	42.7	45.2	39.5	31.2
International reserve assets (USD bn)***	20.4	21.4	26.0	29.0	32.2	32.3
Unemployment rate (%; Kuwaiti nationals)	3.6	2.9	4.7	4.7	4.7	5.0

Source: IMF, CEIC, MARC Economic Research

Note: pl: preliminary pr: projection

** Kuwaiti fiscal year runs from April to March. 2014, for example, refers to FY2014/15*

*** Excludes debt of the Kuwait Investment Authority related to asset management operations*

**** Does not include external assets held by the Kuwait Investment Authority*

Key Strengths

Financially stable economic system supported by large oil reserves

Kuwait, a high-income non-OECD country, has one of the oldest and most financially stable economic systems in the Middle East. A large oil producer, its oil reserves are expected to last more than 80 years at the current rate of production. In 2014, it produced 2.867 million barrels of crude oil a day.

In 2014, real GDP growth fell from the recent post-GFC high of 10.6% in 2011 to a post-GFC low of 0%. The economy had grown 1.0% the previous year. Meanwhile, real oil sector GDP growth contracted by 1.9% from the previous year (2013: -0.8%) due to lower oil prices, as well as lower oil production on account of the closure of a neutral zone oilfield in the latter half of the year. Non-oil sector growth had also slowed to an estimated 3.2% (2013: 4.2%) because of moderating activity in the manufacturing, trade, electricity, water and transportation sectors.

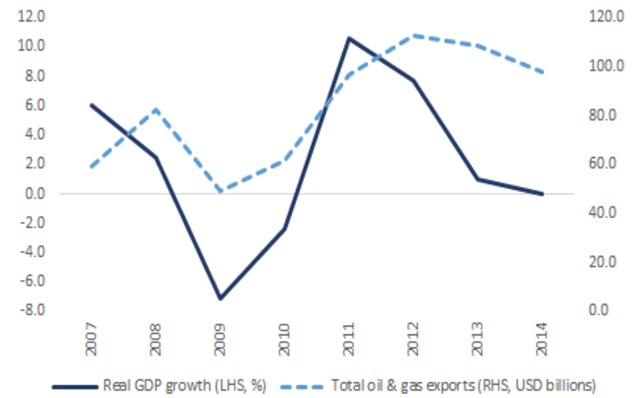
The IMF expects growth in 2015 to rebound slightly to 0.3%. Over the short term, growth will likely remain in positive territory mainly on the back of non-oil sector growth as oil production is expected to remain broadly flat. According to the IMF, Kuwait's economic growth will likely improve further in 2016 to 2.4%, with the government continuing to use accumulated financial buffers to cushion some of the growth impact from lower oil prices.

While Kuwait is one of the most financially stable economic systems in the region, it needs to diversify the economy and strengthen growth potential. It has to ensure that diversification efforts emphasise areas where there is greater potential for national employment. It needs to tackle weak governance and institutions, which have led to an unattractive business environment. It also needs to improve the quality of its education, as well as ensure adequate skill development. As around 20% of Kuwait youths aged between 15 and 24 are unemployed, there is risk of social unrest if diversification efforts are unsuccessful.

Notwithstanding the issues Kuwait currently faces, they are not expected to be an immediate threat to the financial stability of the economic system over the short to medium term. The economic system is expected to remain stable as the growth environment will likely continue to be enabled to some extent by the government's large financial buffers.

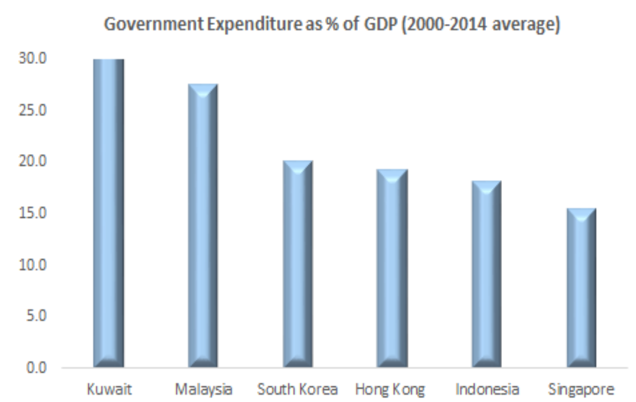
Some USD115 billion will be spent on projects under the National Development Plan (2015–2019) to diversify the economy away from its overdependence on oil and support non-oil growth. However, the government needs to ensure that poor governance and institutions do not come in the way of public spending to sustain economic growth and develop the economy. In 2013, for example, Kuwait's real GDP growth fell significantly to 1.0% from 7.7% in the previous year, partly due to a slowdown of big infrastructure projects because of bureaucratic red tape and political conflict between the cabinet and parliament.

Chart 1: GDP growth and oil and gas exports



Source: World Bank, IMF, MARC Economic Research

Chart 2: Government expenditure



Source: IMF, MARC Economic Research

Large fiscal and external buffers

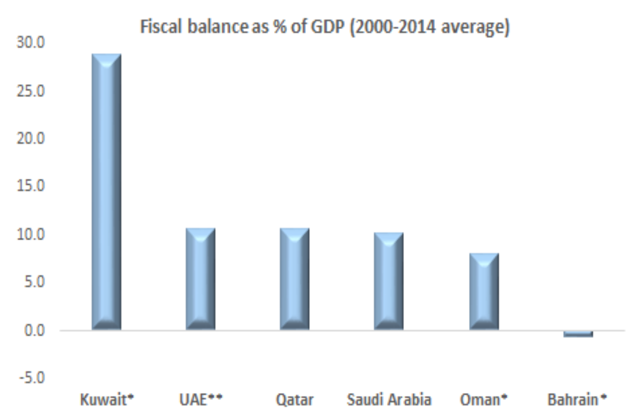
Kuwait's fiscal position is strong, thanks to the monetisation of its considerable oil reserves. It is a high per capita oil producer, that is, it devotes less of its oil revenues to meeting the needs of its population. As such, its fiscal breakeven oil price is low (IMF's 2015 estimate: USD49.4 per barrel).[1] This has enabled the Kuwaiti government to generate large fiscal surpluses over the years. As a result, the government has built up a large fiscal buffer, which gives it a large fiscal space. The KIA manages assets worth more than USD590 billion (June 2015), which is equivalent to about 326% of GDP and more than 700% of total government expenditure. This fiscal buffer is important as the government can use it to cushion some of the growth impact from lower oil prices. Meanwhile, total government gross debt remains very low. At end-March 2015, government gross debt stood at just 3.2% of GDP.

Kuwait's external payments position is also strong, having generated high CA surpluses over the years. This is not surprising considering that Kuwait's external breakeven oil price (IMF's 2015 estimate: USD38.7 per barrel) is the lowest among Gulf Cooperation Council (GCC) member countries.[2] High average CA surpluses have helped keep its vulnerability to external financial and economic risks low. According to the IMF's projections, Kuwait's international reserve assets stood at USD32.3 billion at end-2014, enough to cover 7.6 months of imports of goods and services. Meanwhile, the USD590 billion worth of assets managed by the KIA also form a significant buffer to external shocks. As expected, Kuwait has a strong net international investment position (NIIP), which is indicative of its position as a creditor nation. The latest data show that as of end-2013, it stood at a massive USD116.5 billion, signalling Kuwait's resilience to volatility in the international financial markets.

[1] *The fiscal breakeven oil price is an annual estimate of the average oil price that is needed for an oil-exporting country to balance its tax revenues with its public expenditure in a particular year. Its main determinants are: a) fiscal revenue tax policy; b) inflation level; c) exchange rate trend; and, d) level of public expenditure. As such, the estimated fiscal breakeven oil price will rise as public expenditure increases.*

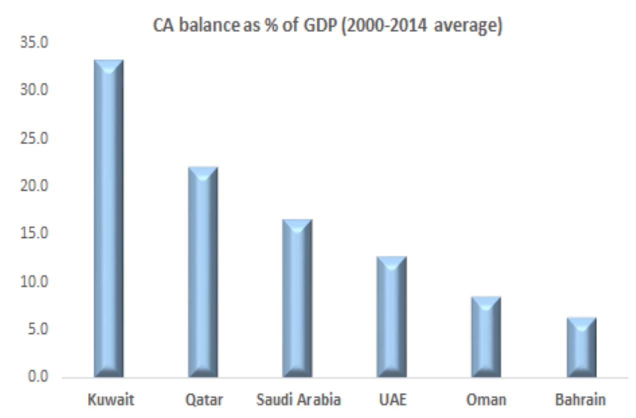
[2] *The external breakeven oil price is the oil exporting price that balances a given country's CA in the balance of payments. As such, higher oil prices would result in a CA surplus, and lower prices in a CA deficit.*

Chart 3: Fiscal balances of GCC member countries



Source: IMF, MARC Economic Research
*Note: * Central government*
*** Central and state governments*

Chart 4: CA balances of GCC member countries



Source: IMF, MARC Economic Research

Major Challenges

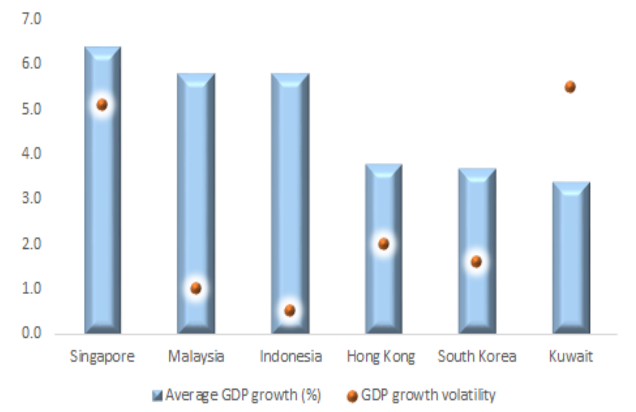
Oil overdependence a source of increasing risk

Oil comprises more than 95% of Kuwait's goods exports. This overdependence has resulted in volatile economic growth, which, research has shown, leads to lower long-term growth rates. This is not surprising because high oil price volatility has a negative economic impact on various types of economies, including net oil exporters. In Kuwait, overdependence on oil has also led to, among other things, large public sector employment, crowding out of the non-oil tradeable sector and declining productivity. The oil sector has also not been creating enough jobs. With the new realities of the global oil market, Kuwait's growth model is fast becoming increasingly unsustainable.

Lower oil prices present a major downside risk for Kuwait's fiscal and external payments positions. Kuwait's fiscal performance has been on the decline. With the oil price collapse of 2014, this issue has become even more critical. In FY2011/12, the government generated a fiscal surplus of 36.1% of GDP, a post-GFC high. By FY2014/15, the surplus had fallen by more than half to 17.4% of GDP. And after mandatory transfers of 25% of total revenues to the Future Generations Fund and excluding investment income, the fiscal balance in FY2014/15 fell to a deficit of 4.4% of GDP, compared with a surplus of 11.7% in the previous fiscal year.

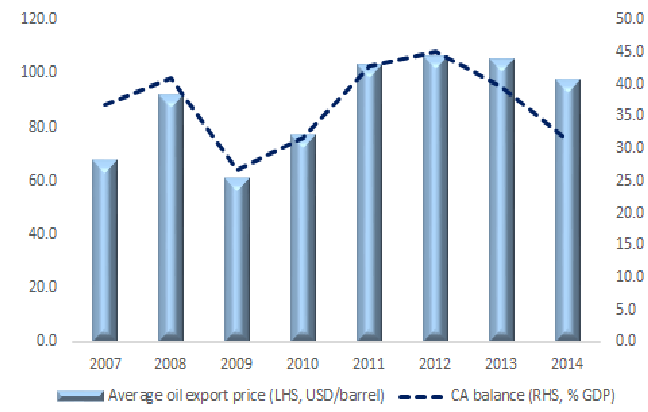
While Kuwait's external performance remains strong by most countries' standards, its CA surplus has fallen somewhat. In 2014, it fell to 31.2% of GDP from the post-GFC high of 45.2% (2012) due in part to the collapse of oil prices. It is unlikely that Kuwait's external performance and position will become an issue over the short to medium term because of its low external breakeven oil price. From a long-term perspective, however, it would be prudent to diversify the economy away from its overdependence on oil before the situation deteriorates further because this process takes time.

Chart 5: GDP growth – average and volatility (2010-2014)



Source: World Bank, IMF, MARC Economic Research

Chart 6: Kuwait: Average oil export price and CA balance



Source: IMF, MARC Economic Research

Quality of governance needs to be improved

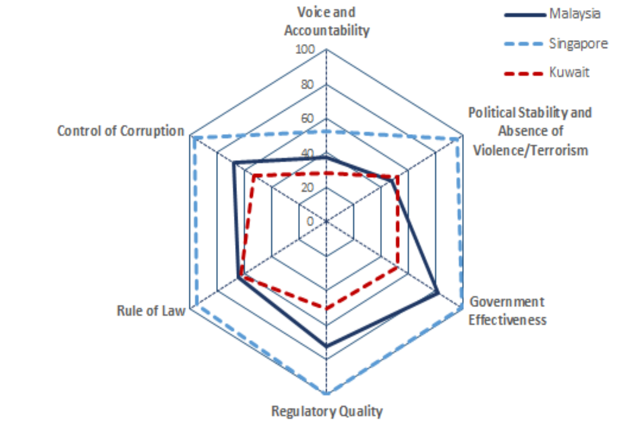
The implementation of public investment priority projects in Kuwait has traditionally been slow and is a major downside concern. Tensions between the executive and the legislature are partly to blame. Up until 2013, political bickering hampered decision-making and the passing of budgets. Such political disputes have affected big ticket contracts and commercial agreements. It is too early to tell how the new national development plan, which commenced in April 2015, will progress, though the 2013-15 period has been one of relative cooperation and stability between the government and the parliament. Kuwait is a semi-constitutional monarchy, and its citizens enjoy a margin of freedom not found in other Gulf countries.

On top of political disputes, Kuwait's institutions are weak. It is lowly ranked in the World Bank's Worldwide Governance Indicators (WGI) project. In the 2014 updated report, Kuwait ranked lower than Malaysia in all six indicators – namely voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Compared to Indonesia and India, however, its percentile ranking for voice and accountability was lower while those of the other indicators were all higher. As weak institutional structures open the way for chaos, civil strife and social disintegration, it is important that the government strengthens governance.

Kuwait's low ranking in the World Bank's Ease of Doing Business 2015 report also reflects its weak governance record. In the latest report, Kuwait ranked at number 86 out of 189 economies, compared to Malaysia's 18th ranking. In the ten areas where the report provided a distance to frontier score, there were only four areas in which Kuwait showed improvements compared to 2014. Even then, the improvements were marginal.

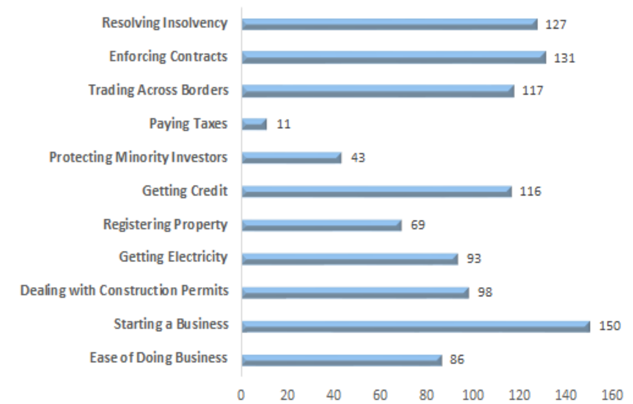
As for geopolitical risks, conflict across wide areas of Syria and Iraq risk spilling over into the country and this is a major concern.

Chart 7: World Governance Indicators, 2014 Update



Source: World Bank
Note: Percentile ranking; higher is better

Chart 8: World Bank Ease of Doing Business 2015



Source: World Bank
Note: Ranking out of 189 economies; lower is better

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