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Country Risk Monitor: State of Kuwait

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In a nutshell

- Kuwait, with a gross domestic product (GDP) per capita in purchasing power parity (PPP) terms of 73,245.7 in current international dollars, is among the world's richest countries. At the current pace of production, its large proven crude oil reserves are expected to last more than 80 years. It is a key member of both the Organisation of the Petroleum Exporting Countries (OPEC) and the Gulf Cooperation Council (GCC). It also has one of the oldest and most financially stable economic systems within the Middle East. Oil revenues have had a major role in driving Kuwait's economic growth. The economy has been largely state-led, with the private sector playing a limited role. The government is trying to change all that. It has been busy implementing development plans to, among other things, diversify away from the oil sector and enable the private sector to take up the lead role in national development.

- Thanks to fiscal surpluses that had averaged above 20% of GDP over the past ten years, Kuwait has a very substantial fiscal buffer. According to the Sovereign Wealth Fund Institute, the Kuwait Investment Authority (KIA) in June 2015 managed assets equivalent to about 326% of Kuwait's GDP and more than 700% of the government's total expenditure. Public debt also remains very low (2015: 4.4% of GDP). Meanwhile, the collapse of crude oil prices has helped increase the sense of urgency over fiscal reforms. Even before the oil market turmoil, fiscal surpluses had been narrowing. The International Monetary Fund (IMF) estimates FY2015/16's fiscal surplus at 2.8% of GDP, compared to 17.4% in FY2014/15. However, Kuwait's long-expected fiscal deficit situation is already here. The finance minister, in a recent statement carried by the official news agency, has announced that the budget shortfall in FY2015/16 reached KWD4.6 billion dinars, equivalent to about 13% of GDP.

- Kuwait also has a very strong external position. Its history of large current account (CA) surpluses has helped keep vulnerability to external financial and economic risks low. In 2015, it churned out a CA surplus equivalent to 10.2% of GDP. According to the IMF, Kuwait's gross official reserves at end-2015 stood at USD29.3 billion, enough to cover 8.2 months of imports of goods and services. This does not include external assets managed by the KIA, which also form a significant buffer to external shocks. As expected, Kuwait is a net international creditor. The latest 2015 data show its net international investment position (NIIP) standing at +USD108.2 billion. Meanwhile, Kuwait's total external debt is relatively low at 35.2% of GDP (2015). Going forward, persistently low oil prices will bring to bear some pressure on its external balance sheet. However, as its external breakeven oil price is low, the lowest among GCC countries, the possibility of its external position being threatened by low oil prices is currently small.

- Meanwhile, Kuwait's medium-term risk outlook continues to be affected by ongoing global economic and financial uncertainties. There are considerable downside risks emanating from, among others, its high dependence on oil, political bickering between the parliament and the executive, as well as the troubled region.

- While the oil sector has generated massive fiscal and external buffers, being overly dependent on oil also mean large significant impacts on both fiscal and external balance sheets when oil prices fall. This is particularly so in the case of the fiscal balance sheet. As mentioned above, the long-expected fiscal deficit is already here. The oil turmoil has also led to a deterioration in the macroeconomic environment, causing financial sector risks to rise. Overdependence on oil has also resulted in issues like low job creation, large public sector employment, crowding out of the non-oil tradable sector, and declining productivity.

- Weak governance, institutions and a poor business environment are also risk concerns in Kuwait. Long, drawn-out political bickering between the cabinet and the parliament has not helped. With both political will and public pressure not having yet reached critical mass, political structures will likely remain more or less unaltered over the short to medium term. This will affect the pace of much-needed reforms to, among other things, improve the business environment. In the World Bank's Doing Business 2016 report, Kuwait ranked at a very low 101 out of 189 economies. Such issues will constrain economic performance, which has already been affected by low oil prices. Against such a backdrop, there could be rising discontent considering the Kuwaitis' sense of entitlement to state-provided benefits. Kuwait also faces rising geo-political risks emanating from, among other things, security threats posed by the activities of the so-called Islamic State in an already troubled region.

Table 1: Kuwait: Selected economic indicators

	2011	2012	2013	2014	2015
Real GDP growth (% y-o-y; at factor cost) #	10.6	7.7	1.0	0.0	0.9
CPI inflation (% y-o-y; period average)	4.9	3.2	2.7	2.9	3.2
Fiscal balance (% GDP)* #	36.1	31.7	34.8	17.4	2.8
Fiscal balance (after transfers to FGF and excl. inv. income)* #	24.7	10.1	11.7	-4.4	-12.5
Total gross public debt (% GDP; calendar year-end)** #	4.6	3.6	3.1	3.2	4.4
Current account (% GDP) #	42.7	45.2	39.5	31.2	10.2
International reserve assets (USD billion)***	26.0	29.0	32.2	32.3	29.3
Unemployment (% total labor force; ages 15-24)	21.6	21.1	20.5	19.4	…

Source: IMF, World Bank, Central Statistical Bureau, MARC Economic Research

*Note: * The Kuwaiti fiscal year runs from April to March. 2014, for example, refers to FY2014/15 in the table*

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

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

 # 2015 data represent estimates

Key Strengths

Large oil reserves, stable economic system

Kuwait, with a GDP per capita PPP of 73,245.7 in current international dollars, is among the world's richest countries. It is a key member of both the OPEC and the GCC. According to statistics published by OPEC, Kuwait has proven crude oil reserves of 101,500 million barrels. At the current pace of production, Kuwait's oil reserves are expected to last more than 80 years.

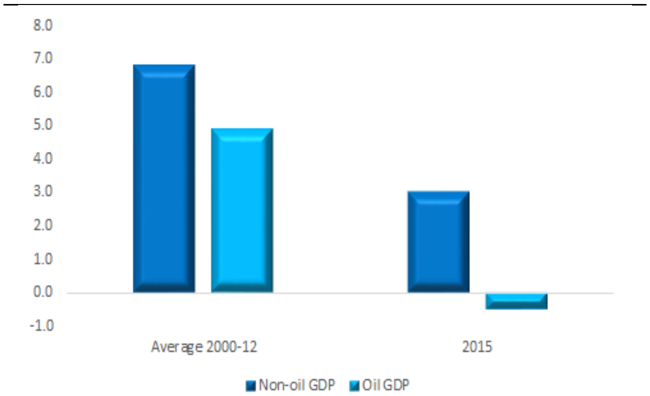
Kuwait has one of the oldest and most financially stable economic systems within the Middle East. Oil exports have contributed significantly towards government revenues. Government spending on the public wage bill, as well as investment, has had a major role in driving Kuwait's economic growth. It has also funded the development of a generous welfare system.

Real GDP growth has been trending downwards since the post-Global Financial Crisis (GFC) high of 10.6%. In 2015, it recovered slightly to 0.9% from the post-GFC low of 0% (2014). The 2015 recovery was due largely to non-oil sector growth of 3.0% (2014: 3.2%). Real oil sector growth continued to contract in 2015, though at a slower pace of -0.5% (2014: -1.9%).

The IMF forecasts GDP growth in 2016 to improve to 2.4%, with non-oil GDP growth keeping to 3.0% and oil GDP growth improving to 2.0%. Notwithstanding the IMF's optimistic forecasts, we see the economy continuing to face challenges because the realities of the global oil market are increasingly making Kuwait's growth model unsustainable in the medium and long term. Oil market volatility has thus affected Kuwait's economic growth and fiscal and external balance sheets. It should be noted, though, that the government has significant fiscal reserves which it can continue to draw on to drive economic growth.

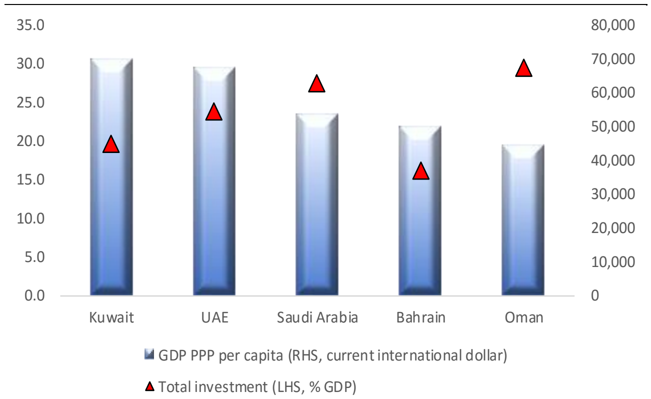
The government has been busy in planning the country's future development. "Kuwait Vision 2035" is a series of five-year development plans extending to 2035 that are aimed at, among other things: a) increasing the GDP and raising living standards; b) encouraging the private sector to play the lead role in national development; and, c) enhancing and improving the government's administrative effectiveness. However, there have been only limited successes thus far on account of weak governance, institutions and business environment.

Chart 1: Oil and non-oil real GDP growth (% y-o-y)



Source: IMF, MARC Economic Research

Chart 2: GDP per capita against total investment of selected GCC economies



Source: IMF, MARC Economic Research

Significant fiscal buffer

Thanks to fiscal surpluses that had averaged above 20% of GDP over the past ten years, Kuwait has a very substantial fiscal buffer. According to the Sovereign Wealth Fund Institute, the KIA in June 2015 managed assets equivalent to about 326% of Kuwait's GDP and more than 700% of the government's total expenditure.

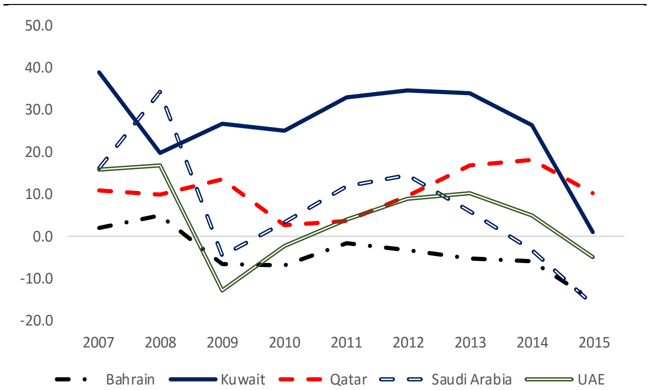
Though its fiscal buffer remains substantial, the government has heeded calls for fiscal reform, with the sense of urgency rising especially after the oil price collapse. Even before the oil market turmoil, fiscal surpluses had been narrowing. The IMF estimates FY2015/16's fiscal surplus at 2.8% of GDP, compared to 17.4% in FY2014/15. However, Kuwait's long-expected fiscal deficit situation is already here. The finance minister, in a recent statement carried by the official news agency, has announced that the budget shortfall in FY2015/16 reached KWD4.6 billion dinars, equivalent to about 13% of GDP.

While fiscal reforms remain ongoing, the pace of reforms is slow because of governance and institutional issues. It is likely that Kuwait's strong fiscal position will continue to deteriorate going forward, albeit slowly, especially if oil prices continue to be in the doldrums. Notwithstanding such concerns, Kuwait's risk profile is unlikely to be seriously affected, at least over the short- to medium-term.

It helps that Kuwait is a high per capita oil producer with a low fiscal breakeven oil price. The IMF estimates Kuwait's 2015 fiscal breakeven oil price at USD49.2 per barrel, the lowest among GCC member countries. Saudi Arabia, for example, has a fiscal breakeven oil price of USD94.8 per barrel. What this means is that the degree of impact of the current low oil prices on Kuwait's fiscal balance sheet is smaller than on Saudi Arabia's.

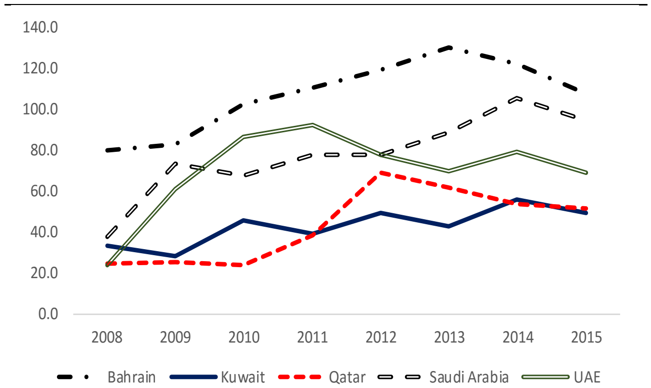
Public debt remains very low at 4.4% of GDP as of end-2015. The government has started boosting domestic debt issues to partly finance its fiscal deficit. It is also expected to finance the deficit through withdrawals from its General Reserve Fund (GRF). As only part of the deficit financing will come from debt issuance, we foresee the amount of debt issued (as a percentage of GDP) specifically for this purpose to be marginal in size.

Chart 3: General government fiscal balance (% GDP) of selected GCC economies



Source: IMF, MARC Economic Research

Chart 4: Fiscal breakeven oil price (USD/barrel) of selected GCC economies



Source: IMF, MARC Economic Research

Solid external balance sheet

A history of large CA surpluses has helped keep Kuwait's vulnerability to external financial and economic risks low. Its low external breakeven oil price has ensured this. According to the IMF, Kuwait's external breakeven oil price of USD38 per barrel (2015) is the lowest among GCC member countries. Saudi Arabia, for example, has an external breakeven oil price of USD64 per barrel. What this essentially means is that Kuwait's external balance sheet is not as dependent as Saudi Arabia's on high oil prices.

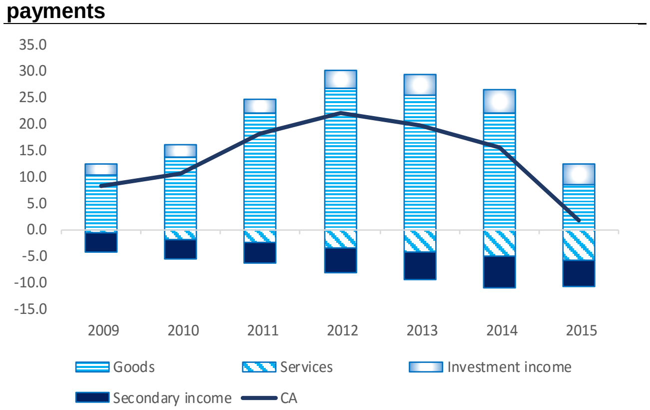
In 2015, Kuwait still managed to churn out a CA surplus equivalent to 10.2% of GDP despite the oil market turmoil. Its gross official reserves in 2015 stood at USD29.3 billion, enough to cover 8.2 months of imports of goods and services. This does not include external assets managed by the KIA, which also form a significant buffer to external shocks. As mentioned earlier, the KIA in June 2015 managed assets equivalent to about 326% of Kuwait's GDP.

Developments in the financial account of the Balance of Payments (BOP), which describes changes in international ownership of assets, show that the net value of recorded external assets owned by Kuwaiti residents continued to rise in 2015, albeit at a significantly slower pace. In 2015, the net value reached KWD2.07 billion (2014: KWD16.35 billion).

Meanwhile, developments in the main BOP items in 2015 resulted in the overall balance falling into a deficit of KWD886 million (2014: +KWD363 million). However, Kuwait's broader BOP balance – which reflects the net investment accounts of the KIA, Kuwait Petroleum Corporation, Kuwait Airways Corporation and Central Bank of Kuwait – remained in surplus in 2015, although sharply narrower at KWD1.62 billion compared to KWD16.43 billion previously.

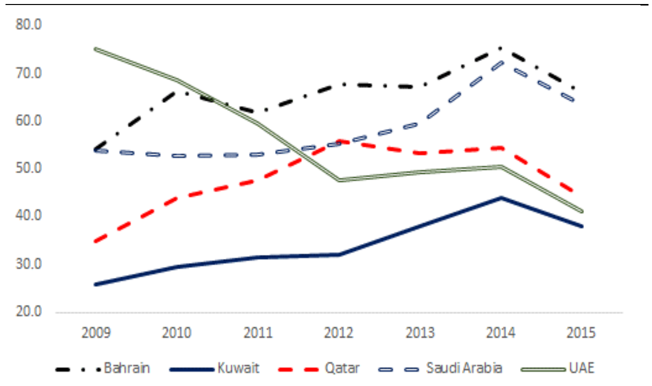
As expected, Kuwait is a net international creditor. The latest 2015 data show its NIIP standing at +USD108.2 billion. Kuwait's relatively low level of total external debt is also a plus point. IMF data show its total external debt at end-2015 standing at 35.2% of GDP, relatively small when compared to the size of state assets managed by the KIA.

Chart 5: Current account (KWD billion) of balance of payments



Source: CEIC, MARC Economic Research

Chart 6: External breakeven oil price (USD/barrel) of selected GCC economies



Source: IMF, MARC Economic Research

Major Risks

Overdependence on oil

While Kuwait's large oil sector has generated massive fiscal and external buffers, being overly dependent on oil has also meant that the impact of the current oil market turmoil on both its fiscal and external balance sheets can be significant. This is particularly so in the case of the fiscal balance sheet which, according to IMF estimates, will fall into a "paper deficit" (FY2015/16: 12.5% of GDP; FY2014/15: 4.4%) after mandatory transfers to the Future Generations Fund (FGF) and excluding investment income.

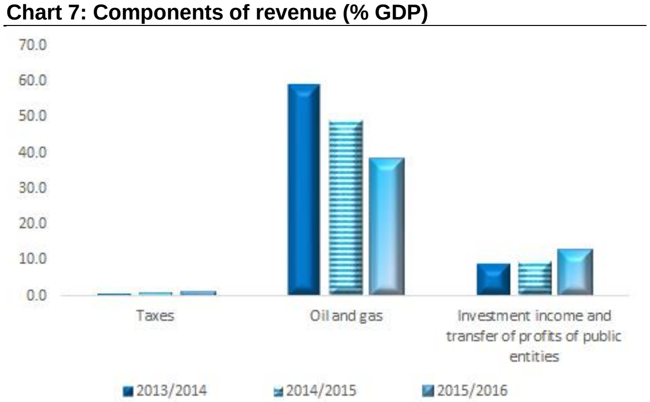
According to a news report from the official news agency, however, the long-expected pre-FGF fiscal deficit has already happened. The finance minister has announced that Kuwait recorded a budget shortfall of KWD4.6 billion dinars (USD15.3 billion) in FY2015/16, equivalent to about 13% of GDP. Meanwhile, the government expects the deficit to rise to KWD9 billion in FY2016/17 on the assumption that oil prices will average around USD35 per barrel.

The oil turmoil has also caused a deterioration in the macroeconomic environment, which in turn has increased financial sector risks. This is a concern because empirical studies show that there exists a feedback loop between oil price movements, bank balance sheets, and asset prices in the GCC economies. This has important implications for financial systemic risk in Kuwait, which is an ever present concern because of close and complex connections among banks, sovereign and investment companies, and industrial and commercial groups.

It is important to note that banks and financial services counters make up about 30% of the counters listed in the local bourse. As such, the impact of a sell-off in financial stocks due to perceived difficulties in the banking sector could lead to severe macro financial stress. Going forward, a sustained low oil price environment will likely continue to impact liquidity, risk appetite, credit risks, and balance sheet repair in the banking sector.

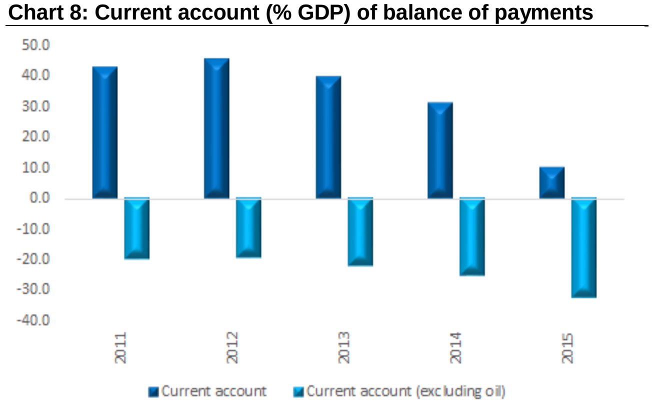
Overdependence on oil has also resulted in issues like low job creation, large public sector employment, crowding out of the non-oil tradable sector, and declining productivity. Against such a backdrop, the implementation of recommended reforms to ensure long-term fiscal sustainability could lead to rising social tensions that will affect economic and political stability.

Chart 7: Components of revenue (% GDP)



Source: IMF, MARC Economic Research

Chart 8: Current account (% GDP) of balance of payments



Source: IMF, MARC Economic Research

Weak governance and institutions

Weak governance, institutions and a poor business environment are risk concerns in Kuwait. In the World Bank's Worldwide Governance Indicators (WGI) project, for example, Kuwait is 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.

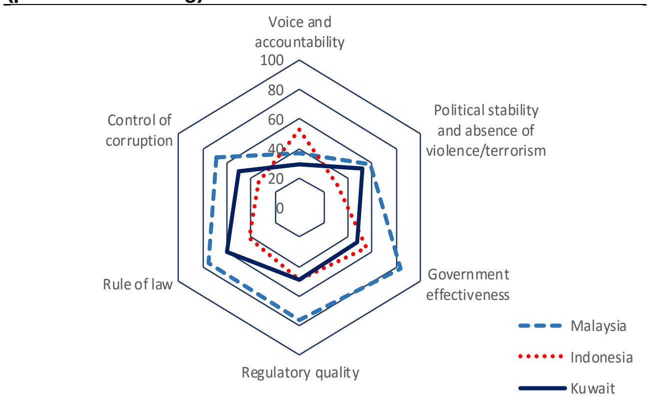
Long, drawn-out political bickering between the cabinet and the parliament has not helped. With both political will and public pressure not having yet reached critical mass, Kuwait's political structures will likely remain more or less unaltered over the short to medium term. This situation is unfortunate because it has been proven time and time again that Kuwait's semi-democratic system is ineffective when dealing with problems like government mismanagement, corruption and lack of economic transparency.

The pace of much-needed reforms to, among other things, improve the business environment continues to be affected. The political bickering will likely continue affecting big ticket contracts and commercial agreements. For example, the government finally signed the contract for building the USD16 billion al-Zour oil refinery in October 2015, originally planned more than a decade ago.

Such issues will constrain economic performance, which has already been affected by low oil prices. Government revenues have been affected by low oil prices, and long, drawn-out periods of fiscal reforms could lead to rising discontent among Kuwaitis, considering their sense of entitlement to state-provided benefits. The situation is complicated by Kuwait's strategic location bordering the three major markets of Saudi Arabia, Iraq and Iran across the Gulf. As these three large neighbours are the centres of sectarian and political influence, Kuwait, being a very small economy with a very small population, has sometimes had to put its interests behind its neighbours'.

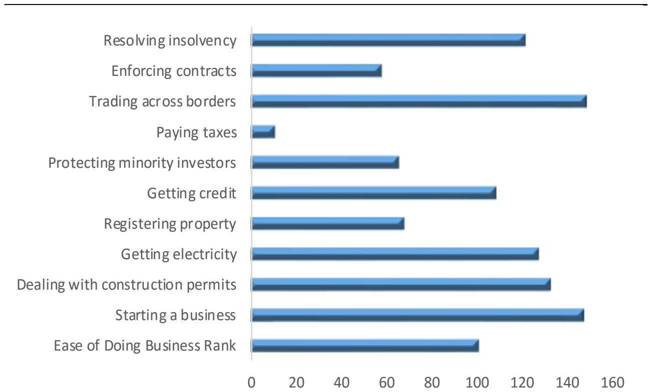
There is also the problem of rising geo-political risks emanating from, among other things, security threats posed by the activities of the so-called Islamic State in an already troubled region. In June 2015, Kuwait suffered one of the bloodiest assaults in its history when a deadly suicide bombing linked to the Islamic State took place in one of its largest Shiite mosques.

Chart 9: World Governance Indicators, 2015 Update (percentile ranking) of selected countries



Source: World Bank

Chart 10: Kuwait: Ease of Doing Business 2016 (ranking)



Source: World Bank

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