Economic Research

KDN No.: PP14787/11/2012(030811)

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/015/2017

Country Risk Monitor: Kuwait

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30 November 2017

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In a nutshell

- Kuwait's economic strength remains dependent on its substantial oil reserves. One of the world's richest countries, it also has one of the oldest and most financially stable economic systems in the Middle East. Government spending on the public wage bill and investment remains an important engine of economic growth. Kuwait has had to face economic, fiscal and external challenges over the past two years because of low oil prices. With oil prices having recently improved, we see better prospects ahead for the Kuwaiti economy. In any case, we see it moving in the right direction in terms of building a more sustainable economy with the support of its substantial oil reserves, high financial buffers and substantial borrowing space.

- Kuwait's development model remains mostly funded by oil and natural gas revenue, and large financial buffers should provide adequate fiscal space to keep the economy going. Its sovereign wealth fund is estimated to hold financial assets equivalent to about 460% of gross domestic product (GDP). To finance part of the previous fiscal year's deficit, the government made an international bond debut in March 2017. Kuwait's total gross debt, while still relatively low, has ballooned to about 12% of GDP. If the global oil market continues to improve, we expect Kuwait's fiscal performance to also improve. Against such a backdrop, however, it is likely that there may be more opposition to fiscal reform efforts. As it is, already belated diversification efforts have been relatively insubstantial because of weak institutions and a poor doing business environment.

- Kuwait persistently ran large current account surpluses in the past. As a result, it has accumulated large external buffers. Given its strong external position, its vulnerability to external financial and economic risks remains low. Meanwhile, improving oil markets have somewhat lessened concerns about the possibility of its current account balance falling into a deficit. It is noteworthy that Kuwait has among the lowest external breakeven oil prices in the Middle East. It is also a net international creditor, and its international reserves (2016: USD31.5 billion) are enough to cover 6.9 months of imports of goods and services. Note that this figure does not include external assets managed by the Kuwait Investment Authority. The assets, at more than KD530 billion, also serve as a buffer against external shocks.

- Kuwait's risk outlook continues to be buffeted by global economic, financial and geopolitical developments. The most important downside risks, however, come from its oil dependency and domestic political tensions and instability.

- Highly dependent on the oil sector, Kuwait's development model has been mostly funded by oil and natural gas revenue. Significantly depressed oil prices in the recent past had put pressure on Kuwait's fiscal and external balances, leading to budget financing needs. The country's high dependence on oil also means that its economy is vulnerable to the deleterious effects of whipsawing oil prices. It also led to structural issues that include low job creation and declining productivity. While a lot more needs to be done to diversify the economy and income, which is an absolute necessity because the development model is unsustainable, reform efforts continue to be stymied by weak institutions and a poor doing business environment.

- Kuwait's 50-seat parliament is often truculent and tensions between it and the ruling Al-Sabah family persist. With six national assemblies dissolved over the last decade either because of political disputes or due to procedural flaws, Kuwait remains politically unstable. In the snap elections of November 2016, the opposition won big in what is widely perceived as an anti-austerity vote. As a result, there are fears of fresh political wrangling. Regionally, there are potentially destabilising spillovers from geopolitical developments that could shape the future of the Gulf. Security concerns are also high in Kuwait because of activities of Iran-linked Shia armed militias across the border in Iraq.

Table 1: Selected economic indicators

	2011	2012	2013	2014	2015	2016
Real GDP (%)	10.6	7.7	0.4	0.6	2.1	2.5
CPI inflation (%; period average)	4.9	3.2	2.7	2.9	3.2	3.2
Fiscal balance (% GDP)	36.1	31.7	35.6	18.5	0.0	0.7
Fiscal balance (% GDP; after transfers to FGF and excl. inv. income)	24.7	10.1	20.0	2.4	-17.5	-17.3
Total gross public debt (% GDP; calendar year-end)*	4.6	3.6	3.1	3.4	4.7	12.0
Current account (% GDP)	42.7	45.2	39.9	33.4	5.2	4.5
Current account (excl. oil; % GDP)	-20.1	-19.7	22.4	-26.5	-37.6	-35.9
International reserve assets (USD billion)**	26.0	29.0	32.2	32.3	28.3	31.5
- in months of imports of goods and services	7.5	7.7	7.5	7.4	6.5	6.9
Unemployment rate (%)	2.2	2.0	1.9	1.7	1.1	1.3

Source: IMF, World Bank, CEIC, MARC Economic Research
*Note: * Excludes debt related to asset management operations of the Kuwait Investment Authority.*
*** Excludes external assets held by the Kuwait Investment Authority.*

Key Strengths

Stable economic system supported by large oil reserves

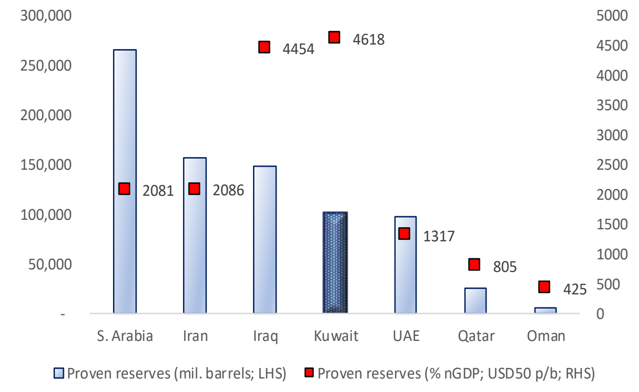
Kuwait's economic strength remains dependent on its substantial oil reserves, which are expected to last more than 80 years at the current pace of production. With a GDP per capita PPP (purchasing power parity) of 73,817 in current international dollars (2015), Kuwait is one of the world's richest countries. It also has one of the oldest and most financially stable economic systems in the Middle East. Government spending on the public wage bill and investment remains an important engine of economic growth.

The country's real GDP growth pace has moderated significantly since the post-Global Financial Crisis (GFC) high of 10.6% achieved in 2011. In 2016, the economy expanded by 2.5%, higher than the post-GFC low of 0.4% in 2013. While non-oil sector activity continues to expand, the pace has slowed because of lower oil prices. It expanded by 3.2% in 2016, slightly slower than the 3.5% pace in 2015, as higher uncertainty weighed on consumption. GDP growth pace in the oil sector, on the other hand, accelerated slightly in 2016 to 1.9%.

With oil prices improving, Kuwait will likely see its real GDP growth pace rising in tandem, i.e. assuming that the momentum of the price increases is sustained. The non-oil real GDP growth pace will also likely improve on expected better project implementation of the current second five-year Kuwait Development Plan under "Kuwait Vision 2035." It is worth remembering, though, that oil prices are inherently unstable, and that volatile oil prices will cause high GDP growth rate volatility in oil economies. Also, a low oil price environment has a negative impact on the performance of economic growth drivers in oil economies. It is for these and several other reasons that Kuwait needs to diversify its economy away from an overdependence on the oil sector.

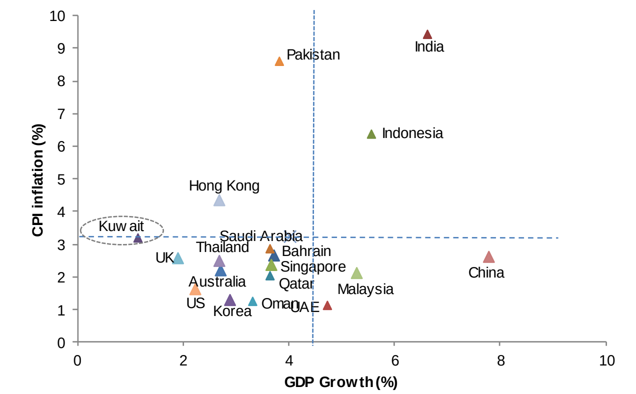
While there may be less pressure on the Kuwaiti economy as well as on fiscal and external balance sheets because of improving oil prices, challenges nevertheless remain. We see Kuwait moving in the right direction, albeit at a slow pace, as it implements reform measures to ensure a more sustainable development path. The successful implementation of Kuwait's reform measures, however, will depend on how successfully it improves governance. A case in point: governance issues had bogged down the implementation of the first Kuwait Development Plan (2010-2014).

Chart 1: Proven crude oil reserves



Source: IMF, OPEC, MARC Economic Research

Chart 2: CPI inflation and GDP growth



Source: IMF WEO Database, MARC Economic Research
Note: 5-year median

Large financial buffers and low debt

Kuwait's most important challenge is financial because its development model remains mostly funded by oil and natural gas revenue. While there are belated efforts to diversify the economy and income, the results have been relatively insubstantial because of weak institutions and a poor doing business environment. However, its large financial buffers should provide adequate fiscal space to keep the economy going if the momentum of improving oil prices is not sustained. Its sovereign wealth fund, the Kuwait Investment Authority, is estimated to hold financial assets equivalent to about 460% of GDP.

The central government revenue as a percentage of GDP is on a downtrend. In 2016, it collected revenue equivalent to 54.3% of GDP (2011: 74.2% of GDP). Even against this backdrop of falling revenue/GDP ratio, government expenditure as a percentage of GDP has continued to rise. As a consequence, Kuwait's fiscal balance – based on the government's definition, which excludes mandatory transfers to the Future Generations Fund and investment income – fell into a deficit of more than 17% of GDP in 2016.[1] No doubt its fiscal performance should improve going forward if the momentum of rising oil prices is sustained.

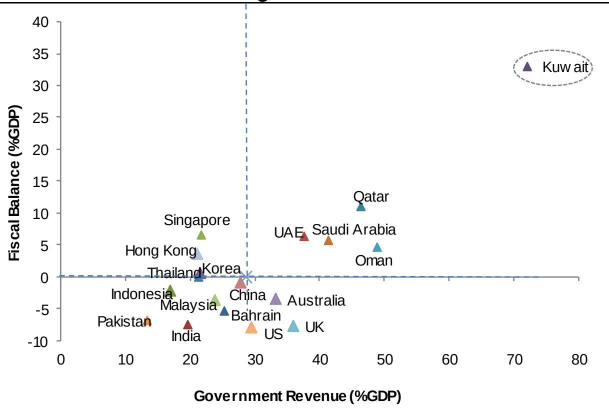
To cover part of the previous fiscal year's deficit, the government made its USD8 billion international bond debut in March 2017. The offering was well received, and drew investors' bids of more than USD20 billion. Kuwait's total gross debt, while still relatively low, has ballooned to about 12% of GDP.

We anticipate Kuwait's fiscal reforms to remain challenging going forward, considering the domestic opposition to it. In fact, opposition could strengthen as oil prices improve further. However, there have been positive results, for example, the successful implementation of the measure to cut petrol subsidies. Current government spending has fallen to about 85% of total spending, compared to about 89% in 2013.

If the improvement in global oil prices is not sustained and the oil market deteriorates further down the road, Kuwait's fiscal position, while currently strong, will likely weaken gradually going forward. It should be noted though that Kuwait is a high per capita oil producer with a low fiscal breakeven oil price of USD46.5 per barrel, the lowest among Gulf Cooperation Council member countries.[2]

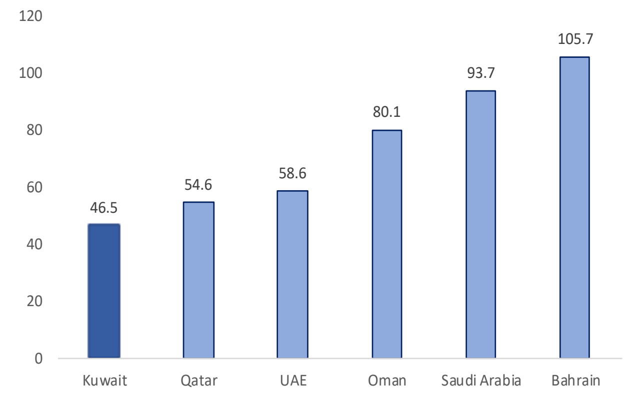
[1] A minimum of 10% of total government revenue is transferred annually to the Future Generations Fund. Income from the Future Generations Fund's investments (mainly foreign assets) is retained in the fund.
[2] The fiscal breakeven oil price is an annual estimate of the average oil price that is needed for an oil-exporting country to balance its tax revenue with its public expenditure in a particular year. Its main determinants are: 1) fiscal revenue tax policy; 2) inflation level; 3) exchange rate trend; and 4) level of public expenditure. As such, the estimated fiscal breakeven oil price will rise as public expenditure increases.

Chart 3: Fiscal balance and government revenue



Source: IMF WEO Database, MARC Economic Research
Note: 5-year median

Chart 4: Fiscal breakeven oil price (USD per barrel; 2016)



Source: IMF, MARC Economic Research

Strong external balance sheet

Kuwait persistently ran large current account surpluses before the oil price collapsed in 2014. For example, its current account surplus over the 2011-2014 period had averaged 40.3% of GDP. Due to these large surpluses, its external balance sheet remains strong and its vulnerability to external financial and economic risks remains low. This despite the fact that its current account surplus has trended downward significantly after the oil price collapse.

With improving oil prices, concerns that Kuwait's current account balance might be on the verge of falling into a deficit have subsided, though this will depend on whether the momentum of improving oil prices is sustained or not. It is important to remember that this concern is somewhat mitigated by Kuwait's low external breakeven oil price, which at USD38.8 per barrel (2016) is among the lowest in the Middle East.[3]

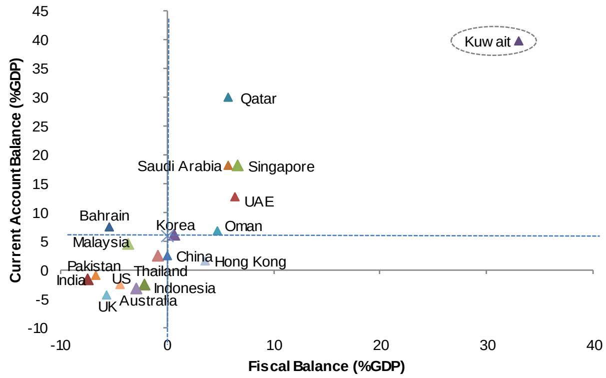
In 1Q2017, Kuwait's current account registered a surplus for the fourth consecutive quarter mainly due to slightly better oil prices. However, on a quarter-on-quarter basis, it fell by 57.0% to KD269 million because of a deteriorating goods balance, falling investment income and rebounding net service outflows. As the deterioration of the goods balance was due to a strong jump in imports, the deterioration is not necessarily bad news when viewed from a savings-investment perspective. It basically indicates that there is progress in the government's development projects, namely the implementation of projects related to the current second five-year Kuwait Development Plan under "Kuwait Vision 2035."

While there were significant concerns over the deterioration of Kuwait's external balance sheet when oil prices collapsed in 2014, it should be noted that the oil state's external position was never threatened given its large external buffers. In 2016, Kuwait's international reserves rose to USD31.5 billion, enough to cover 6.9 months of imports of goods and services. Note that this figure does not include external assets – which also serve as a buffer against external shocks – managed by Kuwait's sovereign wealth fund.

The Kuwait Investment Authority is estimated to hold financial assets equivalent to more than KD530 billion – with roughly two-thirds in the Future Generations Fund and one-third in the General Reserves Fund. As expected, Kuwait is a net international creditor, with the latest available data showing its net international investment position standing at +USD108.2 billion (2015).

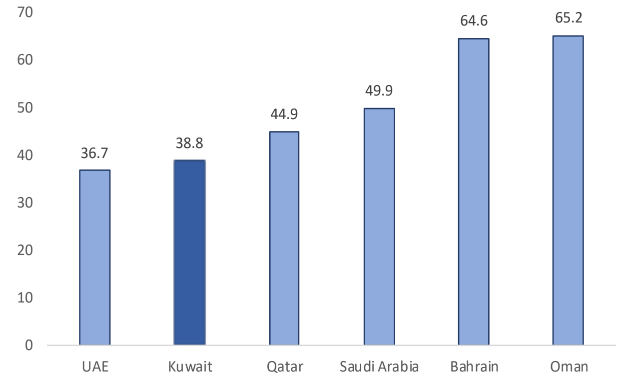
[3] *The external breakeven oil price is an annual estimate of the average oil price that balances an oil-exporting country's current account in the balance of payments.*

Chart 5: Current account and fiscal balances



Source: IMF WEO Database, MARC Economic Research
Note: 5-year median

Chart 6: External breakeven oil price (USD per barrel; 2016)



Source: IMF, MARC Economic Research

Major Risks

Dependence on oil

The Kuwaiti economy is highly dependent on the oil sector. According to statistics published by the Organization of the Petroleum Exporting Countries (OPEC), Kuwait has proven crude oil reserves of 101,500 million barrels as of end-2016.

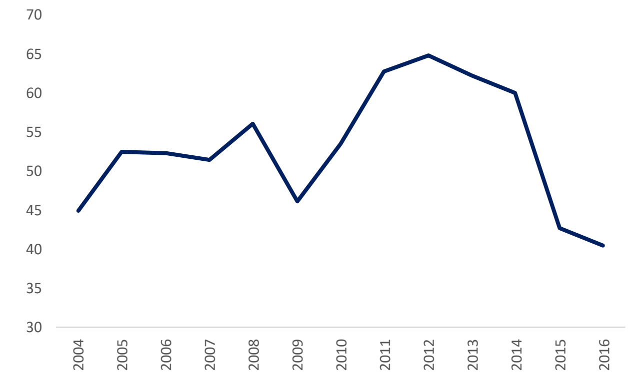
Kuwait's large oil sector and hence its high oil dependency basically means that the funding for its development model has come mostly from oil and natural gas revenue. Government spending on the public wage bill and investment – which helped develop the non-oil sector – continue to play a major role in driving economic growth.

While oil prices have recently improved, low oil prices over the last two years or so have affected Kuwait's fiscal and external balances and have led to budget financing needs. Kuwait's high dependence on oil also means that its economy is vulnerable to the deleterious effects of whipsawing oil prices. Volatile oil prices can cause GDP growth rates to fluctuate wildly and dampen consumer and business sentiments. It also affects investment, thereby reducing the rate of labour and capital accumulation. This, in turn, lowers growth contributions. Growth drivers thus perform less well in an environment of low oil prices.

In addition, Kuwait's high oil dependency has led to long-term structural issues that include: a) a largely state-led economy with large public-sector employment; b) a private sector that plays only a limited role; c) low job creation; and d) declining productivity.

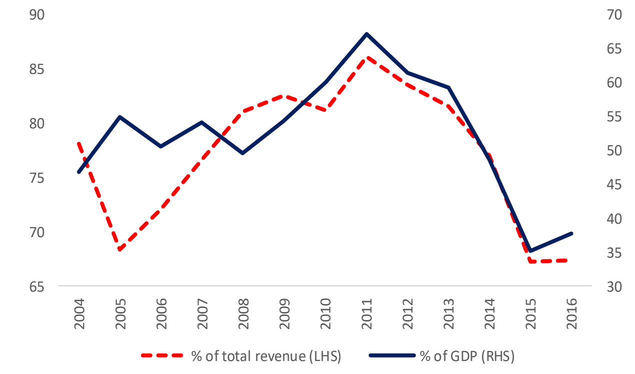
The government has taken steps, albeit belated ones, to rectify the situation. While it takes time to correct such structural issues, the Kuwaiti government's ongoing reform efforts continue to be stymied by weak institutions and a poor doing business environment. With domestic political tensions affecting policy-making and implementation, we expect Kuwait's overdependence on oil to remain a long-running problem.

Chart 7: Oil and gas exports (% of GDP)



Source: IMF, MARC Economic Research

Chart 8: Oil and gas revenue



Source: IMF, MARC Economic Research

Weak governance and institutions

Kuwait's 50-seat parliament, which enjoys legislative powers, is often truculent and tensions between it and the ruling Al-Sabah family persist. On November 26, 2016, Kuwait held its parliamentary election, which was originally scheduled for June 2017. With six national assemblies dissolved over the last decade either because of political disputes or due to procedural flaws, Kuwait remains politically unstable.

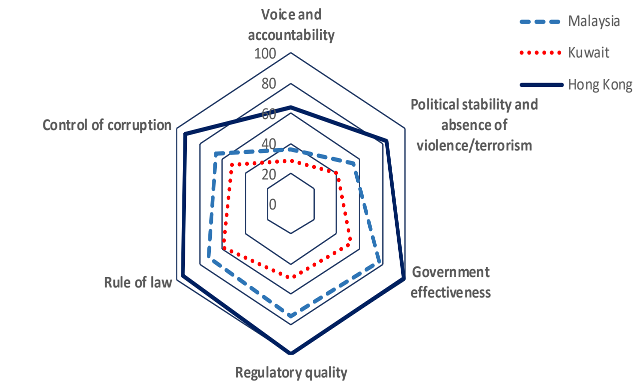
In the snap elections of November 2016, the opposition won big in what is widely perceived as an anti-austerity vote. As a result, there are fears of fresh political wrangling. This would be especially problematic because Kuwait is facing its most acute budget crisis in years, particularly if the recent improvement in oil prices is not sustained. A strong opposition could lead to the watering down of proposed reform measures and subsidy reforms could slow down.

It does not help that Kuwait has issues with its institutions, as evidenced by their low ranking in the World Bank's Worldwide Governance Indicators (WGI) project. As somewhat expected, Kuwait, with its reputation for delays, is also lowly ranked in the World Bank's Doing Business 2018 report.

Regionally, there are potentially destabilising spillovers from geopolitical developments that could shape the future of the Gulf. As political life in Kuwait is more vibrant and civil society more robust than in most of its neighbours in the Gulf Cooperation Council, there are fears that it may be pressed to undertake major policy reorientations. Such concerns will likely become more intense if Kuwait were to become more politically unstable.

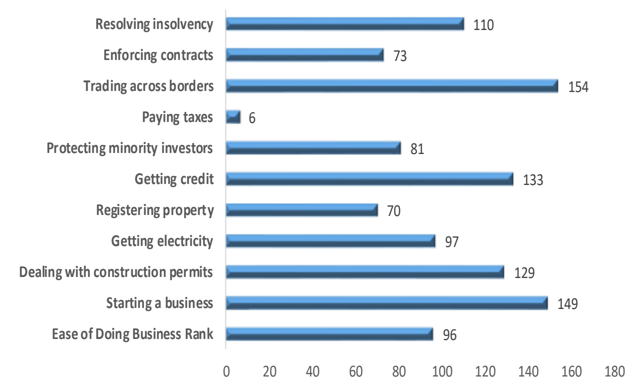
Security concerns are also high in Kuwait because of activities of Iran-linked Shia armed militias across the border in Iraq. Iran-affiliated Iraqi militias have, in line with Iran's regional foreign policy, talked about activities outside Iraq. The Iraqi invasion of Kuwait had amply demonstrated the enormous vulnerability of a small, resource-rich state surrounded by large powerful neighbours in a volatile region.

Chart 9: World Governance Indicators, 2016 Update



Source: World Bank, MARC Economic Research
Note: percentile ranking

Chart 10: Kuwait: Ease of Doing Business 2018



Source: World Bank, MARC Economic Research
Note: ranking out of 190 economies

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