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KUWAIT: Macroeconomic Update

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In a nutshell

- In 2Q2019, real gross domestic product (GDP) rose by 0.4% y-o-y, its slowest pace since 1Q2018. Oil GDP growth, after three quarters in positive territory, came in at -0.4%. Non-oil GDP growth, on the other hand, remained positive at 1.4%. Kuwait remains vulnerable to the vagaries of crude oil prices. The probability of crude oil prices rising to USD100 per barrel anytime soon is remote because of demand and supply weaknesses. The oversupply situation is expected to continue until 2020 because of increased shale oil production as well as rising oil inventories in not only the US but also other developed nations.

- At its October monetary policy meeting, the Central Bank of Kuwait (CBK) cut its policy rate — the first rate cut since September 2012 — by 0.25% to 2.75%. The cut had come on the heels of the US Federal Reserve's (US Fed) third interest rate cut this year. We see the cut as timely given that the Kuwaiti economy continues to sputter as global trade disputes and curbs on oil output put the brakes on growth. However, we do not expect this to result in a burst of economic growth given that in Kuwait, as in most of its oil-rich regional neighbours, fiscal policy is the main driver of economic growth.

- The government is continuing its efforts to rationalise spending and preserve its fiscal buffers. The Ministry of Finance (MOF), after recently rejecting initial estimates of the national budget for fiscal year 2020-2021, is urging government bodies to submit a "realistic" budget. Meanwhile, we see the planned introduction of the value-added tax (VAT) boosting Kuwait's fiscal performance. Having already been postponed once because of political opposition, it is possible that it could be postponed again following reports that the National Assembly has yet to give its consent.

- Kuwait's oil-based economy has come under threat from regional geopolitical tensions, which have spilled into the Strait of Hormuz. Given that Kuwait's entire oil exports pass through the narrow strait, any closure would have severe implications for the economy and the government's financial balance sheet. Meanwhile, the Iranian government is persuading Arab leaders to join the Hormuz Peace Endeavour (HOPE) to try to ensure security and peace among Gulf Cooperation Council (GCC) members. The initiative has generated some positive feedback from regional countries, though the Kuwaiti government is still reviewing it.

DEVELOPMENTS AND OUTLOOK

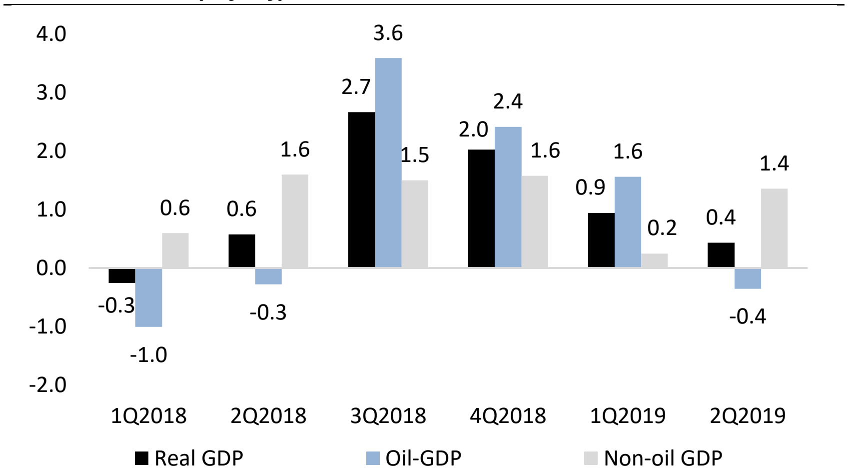
Economic growth slowed down further in 2Q2019

- In 2Q2019, real GDP rose by 0.4% y-o-y, its slowest pace since 1Q2018. Oil GDP growth, after three quarters in positive territory, came in at -0.4%. Non-oil GDP growth, on the other hand, remained positive at 1.4%. The decline in oil GDP in 2Q2019 was unexpected given that crude oil export prices had been relatively firm at about USD66.6 per barrel during the quarter. In fact, when prices were lower at around USD52.9 per barrel in 4Q2018, oil GDP had still managed to expand by 2.4%.

- Kuwait remains vulnerable to the vagaries of crude oil prices. The probability of crude oil prices rising to USD100 per barrel anytime soon is remote because of demand and supply weaknesses. The global economic slowdown, due in part to the US-China trade war, has reduced the demand for oil. In terms of supply, there is an excess of 0.9 million barrels per day, according to the International Energy Agency. The agency expects the oversupply situation to continue until 2020 because of increased shale oil production as well as rising oil inventories in not only the US but also other developed nations.

- In its Vision 2035, Kuwait aspires to move away from its dependence on oil towards non-oil sectors such as finance, information technology and construction. After public administration and defense, the financial sector is the second-largest non-oil and gas related sector. Making up nearly 20% of non-oil GDP and almost 9% of total GDP, we believe it has the potential to accelerate non-oil GDP growth. Meanwhile, Kuwait's recent upgrade from MSCI Frontier Markets to MSCI Emerging Markets is expected to increase the oil state's attractiveness as an investment destination.

Chart 1: Real GDP (% y-o-y)



Sources: Central Statistical Bureau, MARC Economic Research

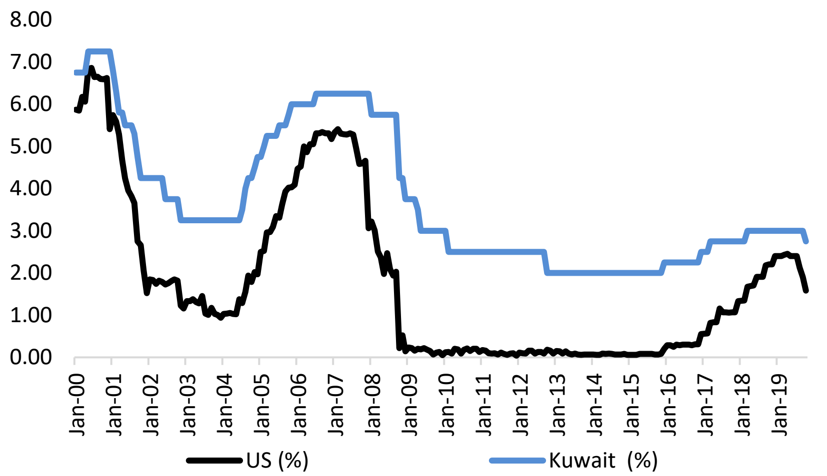
Interest rate cut in October was first since September 2012

- At its October monetary policy meeting, CBK cut its policy rate — the first rate cut since September 2012 — by 0.25% to 2.75%. The cut had come on the heels of the US Fed's third interest rate cut this year. Kuwait, unlike its regional neighbours, pegs its currency against an undisclosed basket of currencies. This means that it has more flexibility when setting interest rates.

- Since 2015, CBK had raised its policy rate only four times, compared with the US Fed's nine times. Against this backdrop, its October interest rate cut is an effort to normalise the interest rate differential with the US now that the spread is back to its historical norm. In any case, the cut is timely given that the Kuwaiti economy continues to sputter as global trade disputes and curbs on oil output put the brakes on growth.

- While lower interest rates will gradually feed through to consumers and businesses, we do not expect it to result in a burst of economic growth. It is important to note that in Kuwait, as in most of its oil-rich regional neighbours, fiscal policy is the main growth driver, with monetary policy playing only a minor role. With the government as the main economic actor, it is up to public spending to support growth.

Chart 2: Kuwait policy rate vs. US effective fed funds rate (%)



Sources: CEIC, MARC Economic Research

Fiscal reform efforts continue, though more political will needed

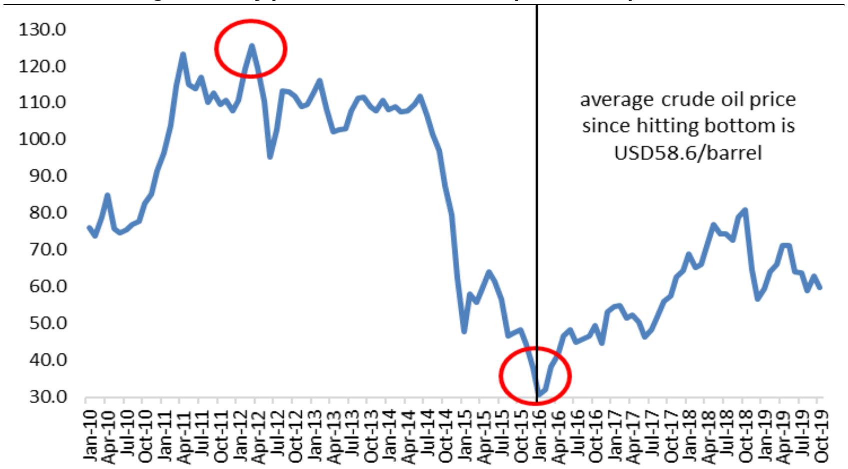
- According to the International Monetary Fund (IMF), the Kuwaiti economy will achieve a balanced budget in 2020 if oil prices average USD54.7 per barrel. Given that oil projections are expected to be above the fiscal breakeven oil price[1] - the US Energy Information Administration (EIA) is projecting USD59.9/barrel and the Organisation for Economic Cooperation and Development (OECD) USD70.0/barrel — the fiscal outlook for Kuwait should improve going forward if the projections pan out.

- Notwithstanding this, the government is continuing its efforts to rationalise spending and preserve its fiscal buffers. In October, the MOF rejected the initial estimates of the national budget for fiscal year 2020–2021. It had called the budget request of KD27.7 billion (USD92.3 billion) by government agencies "unrealistic". The ministry has urged government bodies to review their priorities, mitigate wasteful expenditure and to submit a "realistic" budget.

[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 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.*

- The planned introduction of the value-added tax (VAT) should boost Kuwait's fiscal performance. The VAT, initially set to be implemented in late 2018 or early 2019, had been postponed due to political opposition. In June this year, the government announced that it will implement the new tax on April 1, 2021. However, the possibility of the VAT being postponed again cannot be ruled out following reports by the MOF that the National Assembly has yet to give consent to its implementation. We see another postponement putting pressure on the economy and the government's balance sheet given the backdrop of moderating oil and gas revenue.

Chart 3: Average monthly price of Brent crude oil (USD/barrel)



Sources: CEIC, MARC Economic Research

Risk from geopolitical tensions remain elevated

- Kuwait's oil-based economy has come under threat from regional geopolitical tensions. The tensions have spilled into the Strait of Hormuz, the only sea passage that links the Persian Gulf to the open ocean. As more than a third of the world's seaborne oil and gas passes through the narrow waterway, it is essentially a choke point for the hydrocarbon trade.

- Kuwait's entire oil exports of more than 2 million barrels per day pass through the Strait of Hormuz. Any closure of the narrow strait would severely impact the economy and the government's financial balance sheet given that the output from the oil and gas sector makes up half of Kuwait's GDP. As a share of state revenue, the proceeds constitute at least two-thirds.

- In May 2018, the US withdrew from the Joint Comprehensive Plan of Action (JCPOA), also known as the Iran nuclear deal. Since its withdrawal from the JCPOA, US-Iran tensions have steadily risen. In September, the US "substantially increased" existing sanctions on Iran after it accused the latter of attacks on Saudi Arabia's oil facilities. Tensions reached near boiling point after Iran-backed Yemeni militia known as Houthi allegedly attacked vessels and seized tankers in the Strait of Hormuz.

- To ensure security and peace among Gulf Cooperation Council (GCC) members, the Iranian government is persuading Arab leaders to join a maritime coalition known as the Hormuz Peace Endeavour (HOPE). Not surprisingly, the ultimate aim of the initiative is to see US troops withdrawing from the region. So far, the initiative has generated positive feedback from regional countries such as Bahrain and Saudi Arabia. Meanwhile, the Kuwaiti government is still reviewing details of the initiative.

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