BRIEF REVIEW OF KUWAIT'S ECONOMIC OUTLOOK AND CENTRAL BANK POLICY

National Financing Leasing Company – June Report 2021

On 2 Feb, 2021 Fitch Ratings revised Kuwait's Long-Term Foreign-Currency Issuer Default (IDR) to AA, a change from Stable to Negative from the previous year. The main reason for this revision is the expected depletion, during this year, of liquid assets in the General Reserve Fund (GRF). This risk stems from political tension, e.g. a lack of parliamentary approval for the government to issue debt. Parliament has refused to 1) raise the debt ceiling from KWD 10 to 20 billion, and 2) raise the maximum bond tenure from 10 to 30 years. Fitch says, "*Depletion of GRF liquidity…could result in significant economic disruption. Our base case is that government will replenish the GRF to avoid depletion even without any new legislation by parliament, and that debt service (about KWD 400 million or 1% of GDP in 2021) would in any case continue in a timely manner.*" Government debt/GDP was 17% in 2020, passage of a debt law could increase this to between 50-60% - above the median for AA-sovereigns.[1]
streams are Islamic financing, investment properties and auto leasing.

In August, parliament ended the requirement to transfer 10% of government revenue to the Future Generations Fund (FGF). This legislation was pre-dated to allow for reversal of the transfer made in March 2019. In addition, the GRF has purchased liquid and illiquid assets from the FGF. This included a transfer in January, of Kuwait Petroleum Corporation (KPC) to the FGF. Fitch notes that "*passage of the debt law, deficit reduction and fiscal reform*", is held-up by political disagreements and inflexible expenditures.[2]

According to a report by the Institute of Banking Studies (IBS) Research Unit, government expenditures are statistically uncorrelated with changes in the oil price. In other words, while Kuwait's fiscal revenue is budgeted according to projected oil price and production, fiscal expenditures are not budgeted to reflect anticipated changes in revenue. It is this contradiction between volatile revenues and unresponsive expenditures that is the immediate source of Kuwait's fiscal problem. Politics and labor market conditions merely compound the issue.[3]

ECONOMIC OUTLOOK

2022 will mark the 8th consecutive deficit year. Kuwait's cumulative deficits since the oil price collapse in 2014/15, is KWD 50.6 billion, based on budgeted figures for 2021/22. During 2014-15, the oil price declined over 50%. As a result, between 2014 and 2018, USD 6.5 trillion was transferred from oil-exporting to oil-importing countries, in the form of cumulative revenue decline. [2]

Gains in energy efficiency would (other things being constant) tend to reduce world demand for oil. However, world population growth since 1971, has effectively cancelled out the gains in energy efficiency. Population growth, far more than GDP growth, has driven world demand for oil. It should be noted that the world population growth rate peaked in 1969, and the UN projects population to reach a plateau by 2100. The effects of reduced population growth, especially in developed nations, is likely to contribute to a reduction in oil demand in the mid to long term.

As per Kuwait's 2021/22 budget released on Jan 21 by the Ministry of Finance (MOF), Oil makes up 83% of government revenue, and Salaries and subsidies make up 71.6% of expenditures. Also, According to Fitch, 80% of Kuwaiti nationals are employed in the public sector. Therefore, significant fiscal reform and/or labor force reallocation are not feasible solutions, in the near term. Arguably, the largest expenditure the government could forgo in the short-run is capital expenditures – however, CAPEX only comprises 15% of the budget.

OUTLOOK AS PER FITCH

"***A mild*** *recovery this year as the dual shocks of oil production cuts and the coronavirus begin to fade. We estimate that real GDP contracted by about 7% in 2020* (8% according to TradingEconomics.com), *with the oil sector contracting by 9% and the non-oil sector by 4%. As global oil demand recovers and OPEC production quotas are phased out, there is potential for Kuwait to gradually raise output towards current production capacity of 3.1 million bbl/day.*" Key assumptions made by Fitch include Brent crude averaging USD 45/bbl in 2021 and USD 50/bbl in 2022. Currently, Kuwait's fiscal break-even oil price is USD 90/bbl.[1]

OUTLOOK AS PER FITCH

As of September 2020, the health of Kuwait's financial system may be summarily given as follows[4]:

- Capital Adequacy Ratio = **19%** | Previous year = 18.5% | CBK minimum = 13% | Basel minimum = 10.5%
- Increased mainly due to international issuances.
- Liquidity Coverage Ratio = **184%** | Mandated minimum = 100%
- Net Stable Funding Ratio = **115.3%** | Mandated minimum = 100%
- Regulatory Liquidity Ratio = **27.5%** | Mandated minimum = 18%
- Non-Performing Loans Ratio = **2%** | Previous year = 1.5% | 2015 NPL = 2.4% | 2010 NPL = 9%

This value is near its historic low.

- NPL Coverage Ratio = **222%** | Previous year = 271% | 2015 NPL Coverage = 205% | 2010 NPL Coverage = 62%

Decreased through bad-debts.

- Compounded Annual Growth in Credit Facilities = **6%**

Growth was calculated for period 2010-2020.

The CBK pursued macro-prudential and accommodative monetary policies to bolster lending and financing capacity for local banks, in an attempt to curb the economic effects of the pandemic. The CBK's main macro-prudential measures are the following: Enhancement of **risk management** in banks.

- Increasing **capital bases**.
- Increasing precautionary **provisions**.
- **Basel III** reforms.

OUTLOOK AS PER FITCH

Stress tests performed by the CBK in December 2020, covering Covid-19 impacts on solvency, liquidity, and profitability, indicate financial soundness of Kuwaiti banks. These tests were based on a new framework, using three scenarios of increasing severity: 1) Single sector shock, 2) Multi-sector shock, and 3) Global crisis, each over three years. Under the scenarios of the tests, Kuwait's banking sector averaged a CAR of 11.4% by end-2023 – compared with a Basel minimum of 10.5%.

Banking assets remain healthy due to ample provisions. Aggregate loan loss provisions charge was approximately KWD 852 million in 2020, while the increase in available provisions was KWD 403 million - indicating the remaining KWD 449 million was the value of aggregate bad-debt write-offs in 2020.

The CBK was successful in promoting a growth in credit facilities. Net Credit Facilities balance was KWD 51.8 billion, as of December 2020 – a 4.3% increase y/y. This growth occurred in March 2020, following a lowering of the Discount Rate to 1.5% by the CBK.

Banks net income fell 48.7% y/y in 2020, from KWD 964 million to KWD 495 million. This was a result of 1) lower operating revenue, 2) increased provisions, and 3) moratoriums for consumer, housing, and credit installments.

Measures taken by the CBK between March and September 2020, are tabulated on pages 7 to 11 of the referenced report[4].

IMF REPORT AND SUGGESTIONS

On March 30, 2020 the Executive Board of the IMF concluded the Article IV consultation with Kuwait.
IMF's stance on the fiscal problem is similar to the description in section 1 of this report.
The IMF concludes that Kuwait's banking system is "sound". The real estate market is "stable", and equity markets "outperformed" 2019.

EXECUTIVE BOARD ASSESSMENT[5]

Borrowing should be viewed as a "temporary solution" - as our debt-to-GDP ratio could increase rapidly, under current revenue projections.

IMF proposes the following Fiscal Adjustments:

- "The large public wage bill should be reformed…"
- "…generalized subsidies and transfers [should be] phased out in favor of targeted compensation schemes."
- "…the government should…continue the technical work on the GCC-wide excises and VAT."
- "Taxes on corporate income, luxury items, and personal income of the wealthy…"

"Financial sector reforms should…unwind the blanket deposit guarantees."

"Gradually relax the interest rate ceiling on commercial loans…"

"With limited scope for public employment…private sector must…absorb…large number of Kuwaitis entering the labor market."

(Some estimates are around 100,000 over the next 5 years.)

To improve business environment [the government should]:

- "…revamp insolvency framework,"
- "…reduce excessive regulations,"
- "…and ease trading across borders."

EXECUTIVE BOARD ASSESSMENT[5]

The IMF projects that oil prices will average USD 55/bbl through the next 5 years.
Estimated KIA assets as a percentage of GDP in 2025 is 380.7% - compared with 426.8% in 2020.

The IMF base-line projection is that global demand for hydrocarbons will peak by 2040. In the event of a pervasive Carbon tax, peak oil demand could occur as early as 2030. However, natural gas exports are expected to remain steady. Plastic production is expected to quadruple by 2050. Accordingly, several GCC petroleum companies have begun shifting more resources to plastics manufacture.

REPORT SUMMARY

It appears the CBK has done well in preparing the financial sector over the past decade, and has managed the economic fallout of the pandemic deftly. Kuwait's most pressing issues however, concern fiscal policy more than monetary policy. Therefore, the decisions reached between parliament and the government, the government and the private sector, and lastly Kuwait and other GCC countries, will decide the fate of the economy in the years ahead.

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Thank you.

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