Rabobank

Country report **KUWAIT**

Summary

The turmoil in the Arab world had little impact on Kuwait, although concerns of contagion remain. A large risk lies in the political sphere, where the frequent frictions within the government and between government and parliament severely hamper the legislative process, economic reforms and development spending. The economy remains oil dominated and the private sector is largely dependent on government spending and expatriate labor. The economy needs to diversify away from the oil sector in the long term, but currently grows at an estimated solid 5% in 2012 and forecast 4.6% in 2013. Kuwait has posted fiscal and external surpluses for thirteen years in a row. A large geopolitical risk is the possible confrontation between Iran and the US/Israel.

Things to watch:

- Possible contagion from the Arab Spring, especially from Bahrain
- Continued frictions between the government and parliament
- Risk of an escalation of the conflict between Iran and the US/Israel

Author: **Ashwin Matabadal**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-61601
A.R.K.Matabadal@rn.rabobank.nl

Kuwait

National facts		
Type of government	Constitutional Emirate	
Capital	Kuwait	
Surface area (thousand sq km)	17.8	
Population (millions)	3.6	
Main languages	Arabic (official)	
Main religions	Muslim (85%) other (15%)	
Head of State (president)	Sheikh al-Sabah	
Head of Government (PM)	Nasir Muhammad al-Sabah	
Monetary unit	dinar (KWD)	

Economy (2008)		2011
Economic size	*bn USD*	*% world total*
Nominal GDP	169	0.24
Nominal GDP at PPP	169	0.21
Export value of goods and services	114	0.52
IMF quotum (in mln SDR)	1381	0.64
Economic structure	*2011*	*5-year av.*
Real GDP growth	9.3	4.5
Agriculture (% of GDP)	0	0
Industry (% of GDP)	42	47
Services (% of GDP)	57	53
Standards of living	*USD*	*% world av.*
Nominal GDP per head	45620	423
Nominal GDP per head at PPP	45596	368
Real GDP per head	29403	362

Social and governance indicators	rank / total
Human Development Index (rank)	63 / 187
Ease of doing business (rank)	67 / 183
Economic freedom index (rank)	71 / 179
Corruption perceptions index (rank)	54 / 183
Press freedom index (rank)	78 / 178
Gini index (income distribution)	n.a.
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2011
Main export partners (%)		*Main import partners (%)*	
South Korea	15	US	12
Japan	11	India	10
India	11	China	9
China	8	Saudi Arabia	8
Main export products (%)			
Crude oil			93
Non-oil			7
Main import products (%)			
Intermediate goods			39
Consumer goods			37
Capital goods			24
Openness of the economy			
Export value of G&S (% of GDP)			68
Import value of G&S (% of GDP)			23
Inward FDI (% of GDP)			0.2

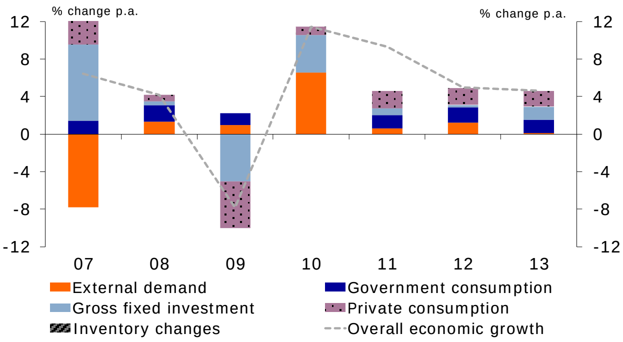
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Kuwait's small economy is undiversified and almost fully based on oil, which is a source of financial strength but at the same time also a severe structural weakness. Kuwait holds 7% of the world's proven oil reserves; equivalent to over 100 years of its current production levels and is now the world's fourth-largest oil exporter. Kuwait's proven natural gas reserves are modest at just 1% of the world total. The state-managed oil sector accounts for around half of GDP, over 80% of general government revenue and 75% of total foreign currency revenues. Structural shortages of water and arable land imply that the prospects for Kuwait's manufacturing and agricultural sectors are extremely limited.

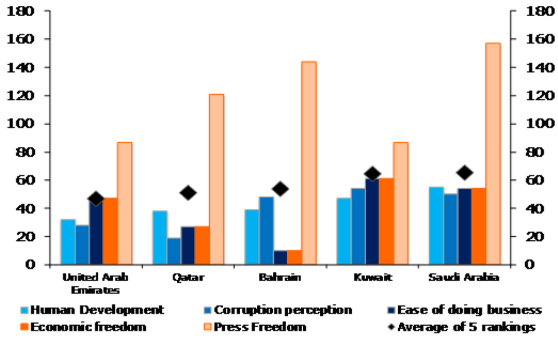
Although a key policy is to increase the number of Kuwaitis working in the private sector, high public sector wages do not stimulate job seeking in the private sector, which employs only 30% of the national labour force. The five-year Development Plan (2009-2014) was approved by parliament in 2010 and aims at improving the country's infrastructure and developing the private sector. The budget of USD 100bn is very large: it represents 80% of GDP 2011, with the private and public sectors each providing half of the total funding. However, about 70% of the total investment is related to the oil industry (refineries and port facilities), with utilities (water desalination, power generation and public transport) in second position. Despite the rhetoric, the actual impact on diversification of the economic structure away from the state dominated oil sector is very low. Furthermore, actual spending is below target, because of the usual disputes between the government and parliament.

Chart 1: Growth drivers



Source: EIU

Chart 2: Social and governance indicators



Source: EIU

Real output is growing by about 4.5% annually. The sharp real GDP contraction in 2009 of 7.8% was a consequence of the global economic crisis leading to lower oil production and exports. The recovery boosted economic growth in 2010 and 2011. Going forward, we estimate economic growth at 5% in 2012 and forecast 4.6% in 2013. Public sector led growth will continue in the forecast period, mostly through an increase of public wages and capital expenditure. Downside risks to this forecast are delays in the projects of the five year development plan and lower demand for oil from the slowing economies in Asia, Kuwait's main export partners.

Overall, the banking sector is stable and the quality of assets held by domestic banks is improving gradually as central bank supervision has strengthened. Bank lending to investment companies declined in 2011 to 9% of total lending from 12% in 2010 as banks have built up provisions against weak loans and written off fully provisioned loans. Non-performing loans have declined as a result, to 7.3% in 2011 from 11.5% in 2010, but remain high. However, the aggregate loan portfolio is still biased to risky segments such as real estate and construction.

Political and social situation

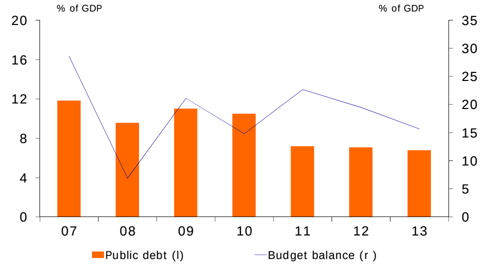
In Kuwait, the Emir, Sheik Sabah al-Ahmad al-Sabah, is head of state and wields executive power. He appoints the government and key ministers are from the Al-Sabah family. Legislative power is held by 50 elected members of parliament (MPs)and 16 government appointed MPs. In addition to passing laws, MPs have the right to question ministers, including the Prime Minister and potentially force them to resign. This original institutional framework, that allows real effective power for elected MPs, makes Kuwait's political system closer to a democratic regime than any of its GCC peers.

The turmoil in the Arab world had little impact on Kuwait. Some demonstrations took place in early 2011. Unlike the small group of stateless Bedouins (4% of the population), the large Shiite minority (30% of nationals) appears fairly integrated in society compared with other GCC countries, which mitigates the risk of social unrest. Moreover, the relatively open Kuwaiti political system –with an elected assertive parliament with legislative powers- absorbs some of the political frustration by standing up to the emir-appointed government. A generous system of welfare already in place also contributes to the support for the overall system among the population. In addition, in response to the Arab Spring spreading in the region and to celebrate the 50th anniversary of Kuwait's independence, the authorities announced major rises in social allowances, public sector wages and subsidies. They even decided to provide free basic food items until March 2012, together at a cost of 3% of GDP.

A significant problem in the political sphere is the frequent friction within and between the emir-appointed government and the parliament, which severely hampers the legislative process, economic policies and development spending. In April 2011, the government was forced to resign, but that is not unusual in Kuwait, with the emir appointing a government under the same prime minister. But the tensions between MPs and the government have deteriorated further in the last year. In November 2011, Prime Minister Sheikh Nasser was forced to resign following harsh disputes with parliament over allegations of corruption and severe street protests in Kuwait city. The National Assembly was then dissolved and new elections led to a victory of opposition MPs (34 out of 50 MPs including Sunni Islamists, Muslim Brotherhood and tribal candidates) in February 2012. In the face of continued tensions between MPs and the government, the Emir suspended the National Assembly for one month in June 2012. A few days later, the Constitutional Court ruled that the February elections were unconstitutional and reinstated the pre-December 2011 assembly. We believe that new parliamentary elections will be held soon. However, the composition of a new parliament will likely be similar to the previous one. As such, we expect political disputes in Kuwait over the next two years to persist as elected MPs continue to press for greater powers.

Kuwait remains a valuable and strategic ally to the US, and the government remains highly supportive of ongoing security relations and anti-terrorism co-operation. A large geopolitical risk is the possible confrontation between Iran and the US. Relations with Iran were formally restored last year, but there is little mutual friendship. The local Shiites, although ethnically not related to Iranian Shiites, may still respond to Iran's calls for loyalty. Relations with Iraq are also complex: war reparation payments dating from the Iraqi invasion in 1990 and competing plans for oil ports on both sides of their disputed common border are unsettled. Furthermore, concerns on contagion from the Arab Spring remain, particularly the high sectarian tensions in Bahrain. Calls from the opposition in Bahrain for the overthrow of the monarchy there, has been worrying for Kuwait's leadership as well as other Gulf States. The issue has raised sectarian tensions within Kuwait, with the majority Sunni population angered by Kuwait's modest backing of the GCC intervention in Bahrain.

Figure 3: Public finances



Source: EIU

Figure 4: Inflation

Source: EIU

Economic policy

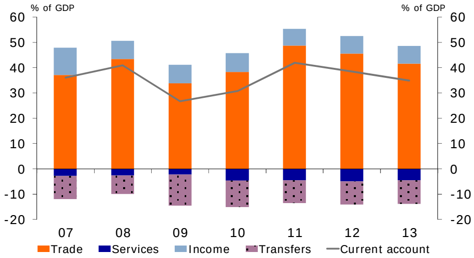
The spearpoint of Kuwait's economic policy is the five year development plan. It aims to diversify the country's source of income and boost the non-oil sector of the economy. Under the plan, Kuwait seeks to speed up its privatization plans, ease land ownership regulations, and reform its cradle-to-grave welfare system. The initiative also includes huge infrastructure projects such as improving the country's airports, roads, and power plants. The plan, which is estimated to cost USD 100bn, was compiled by a total of 78 authorities, including 53 government and 25 civil bodies. Kuwait has the ambition of turning itself into a regional hub for travel and finance.

Nevertheless, the Kuwaiti government has clashed with members of parliament over the country's economic and fiscal policies, and has faced opposition from Islamist members of parliament while seeking to implement liberal reforms. Kuwait has long been overshadowed by its dynamic Gulf neighbors, and lags far behind other Gulf emirates in terms of foreign investment, and faces strong competition in the race of becoming the largest regional financial hub.

The fiscal position is very healthy. On the back of high oil export revenues the government budget has posted large surpluses over the past thirteen years in a row. The budget surplus is estimated at a high 19.5% of GDP in 2012 and public debt remains low, estimated at only 7.1% of GDP in 2012. Even though the public finances are in sound shape and this is expected to continue, structural weaknesses are present. Government revenues are too dependent on oil exports and should be more diversified; income tax is not even levied. Expenditures are too rigid; a huge 85% of total government revenues are geared towards public sector wages, after a large 19% public sector wage hike this year. Furthermore, Kuwait has no fiscal rule in place to contain spending growth when oil prices rise.

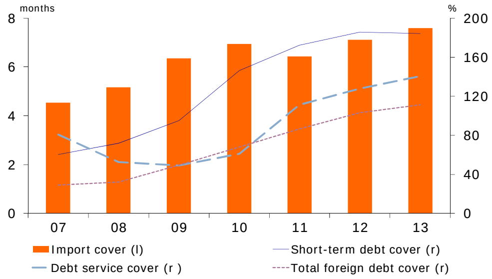
Monetary policy has for decades been geared to stabilize the external value of the dinar, pegged to an undisclosed basket in which the US dollar dominates. According to the most recent review by the IMF in April 2012, the real exchange rate is broadly in line with fundamentals. The low dollarization rate indicates strong confidence in the dinar, which is backed by large government and central bank reserves. Policy interest rates follow those of the US and keep the interbank rates at very low levels of around 1%. Given that most consumer goods are imported, the pegged exchange rate ensures an inflation rate that is not too much out of line with world market price movements. International food price increases and government spending will put upward pressure on the inflation rate, but the decline in housing prices and the government's free-food program will somewhat mitigate these upward price effects. As a result, inflation remains moderate at around 3.5%. Kuwait is strongly in favor of the planned GCC monetary union, but that union encountered political delays and is unlikely to materialize in the short term.

Figure 5: Current account



Source: EIU

Figure 6: Liquidity indicators



Source: EIU

Balance of Payments

Oil accounts for over 90% of the merchandise exports value and almost half of GDP in 2011. High oil prices and steadily growing volumes led to very substantial and continuous trade surpluses, despite increasing import bills. A surplus of 46% is estimated for 2012. Lacking an agricultural and industrial base, almost any final product, either consumer or investment, is imported. On top of this trade surplus, there are net incomes of around 7% of GDP that reflect the financial returns of the large sovereign external funds.

On the outflow side, there are net imports of services of 4% of GDP and more sizable remittances of 9% GDP made by the 2.5m expatriates in Kuwait to relatives in their home countries, mostly in South Asia. The balance on the current account is firmly showing substantial surpluses, in the order of 30% of GDP or higher and another substantial 35% of GDP is forecast for 2013. These structural surpluses reflect the national savings available for direct, portfolio or other types of investment abroad and an increase in FX reserves of the central bank.

External position

The external position of Kuwait is sound. Total external assets, including sovereign and private sector assets held abroad, are estimated to be around USD 300bn, equivalent to 240% of GDP. After subtracting gross external debt, a very strong net foreign assets position of around USD 245bn, equivalent to 200% GDP, remains. These assets are not without value risk, since financial markets losses in recent years negatively impacted the value of the foreign assets portfolio. According to the IMF, the net value of foreign assets declined by 20%. However, this excludes the current account surpluses of over USD 60bn in these two years. Despite these huge losses, the sovereign's and country's net asset position is strongly in the black. Based on projected current account and continuation of large transfers to sovereign wealth funds, this comfortable position should continue in the coming years.

More narrowly defined reserves (only the official FX held by the central bank) have increased to around 7 months of total value of goods and services imports in 2012, while other external liquidity indicators demonstrate a favourable liquidity position as well.

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Kuwait

Selection of economic indicators	2007	2008	2009	2010	2011e	2012f	2013f
Key country risk indicators							
GDP (% real change pa)	6.5	4.2	-7.8	11.4	9.3	5.0	4.6
Consumer prices (average % change pa)	5.5	10.6	4.0	4.0	4.7	3.5	3.2
Current account balance (% of GDP)	36.1	40.9	26.7	30.8	42.0	38.5	34.9
Total foreign exchange reserves (mln USD)	16660	17113	20268	21237	25795	29140	31190
Economic growth							
GDP (% real change pa)	6.5	4.2	-7.8	11.4	9.3	5.0	4.6
Gross fixed investment (% real change pa)	38.7	1.5	-18.9	17.0	2.8	1.4	6.1
Private consumption (% real change pa)	11.6	1.7	-12.0	2.3	5.2	5.0	4.9
Government consumption (% real change pa)	7.3	8.9	6.2	0.0	6.5	8.0	6.7
Exports of G&S (% real change pa)	0.7	5.7	-7.7	12.5	7.5	7.9	5.3
Imports of G&S (% real change pa)	24.7	3.8	-12.5	-0.8	9.9	8.2	7.7
Economic policy							
Budget balance (% of GDP)	28.6	6.9	21.1	14.8	22.7	19.5	15.7
Public debt (% of GDP)	12	10	11	11	7	7	7
Money market interest rate (%)	4.9	2.8	1.6	0.9	0.9	1.1	1.1
M2 growth (% change pa)	19	16	13	3	9	7	10
Consumer prices (average % change pa)	5.5	10.6	4.0	4.0	4.7	3.5	3.2
Exchange rate LCU to USD (average)	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Recorded unemployment (%)	n.a	n.a	n.a	n.a	n.a	n.a	n.a
Balance of payments (mln USD)							
Current account balance	41331	60241	28284	38288	70776	65170	60380
Trade balance	42564	64005	35903	47557	82339	77452	71940
Export value of goods	62526	86944	54435	67620	104299	101551	98260
Import value of goods	19962	22939	18532	20067	21960	24099	26330
Services balance	-3175	-3818	-2277	-5638	-7534	-8241	-7630
Income balance	12395	10743	7685	9419	11096	11558	12190
Transfer balance	-10453	-10689	-13023	-13051	-15126	-15599	-16120
Net direct investment flows	-9672	-9097	-7473	-4748	-8313	-9153	-9680
Net portfolio investment flows	-34904	-28130	-8195	-16868	-9317	-8090	-9180
Net debt flows	26332	-4241	-11852	-12066	-1281	-1658	-180
Other capital flows (negative is flight)	-18987	-18322	2386	-3635	-47305	-42918	-39290
Change in international reserves	4101	452	3150	971	4561	3351	2050
External position (mln USD)							
Total foreign debt	57561	52938	40863	31146	29866	28208	28030
Short-term debt	27538	23783	21330	14496	14976	15704	16930
Total debt service due, incl. short-term debt	20583	32589	41161	34705	23174	22791	22170
Total foreign exchange reserves	16660	17113	20268	21237	25795	29140	31190
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	37.1	43.4	33.9	38.3	48.8	45.7	41.6
Current account balance (% of GDP)	36.1	40.9	26.7	30.8	42.0	38.5	34.9
Inward FDI (% of GDP)	0.1	0.0	1.0	0.3	0.2	0.3	0.4
Foreign debt (% of GDP)	50	36	39	25	18	17	16
Foreign debt (% of XGSIT)	65	47	55	36	24	23	23
Debt service ratio (% of XGSIT)	23	29	55	40	18	18	18
Interest service ratio incl. arrears (% of XGSIT)	5	3	2	2	1	1	1
FX-reserves import cover (months)	4.5	5.2	6.4	6.9	6.4	7.1	7.6
FX-reserves debt service cover (%)	81	53	49	61	111	128	141
Liquidity ratio	187	192	144	162	226	222	219

Source: EIU