Rabobank

Country report **KUWAIT**

Summary

The small and very narrowly oil-based economy (over 80% of government revenues and 90% of export revenues) facilitated the build-up of a very high level of government controlled external reserves. Gross external debt at 43% of GDP is moderate and dwarfed by the (undisclosed) external reserves estimated to reach over 250% of GDP (2010). Although substantial value losses occurred in 2009 and 2010, there are still very comfortable buffers in case the government's needs to bail-out banks or if oil revenues fall sharply.

Companies are largely state-run, paying high salaries and allowances to the privileged Kuwaiti nationals (only one third of the population). Internally, the political and social situation is stable, despite government vs. parliament stalemates on policy issues. Regional geopolitical risks continue to relate to Iran's nuclear aspirations and specific offshore border issues with Iraq. Kuwait maintains strategic alliances with the West and Saudi Arabia, but is gradually shifting diplomatic attention and financial assets to Asian emerging economies.

Things to watch:

- Geopolitical risks (Iran and Iraq)
- Contingent liabilities of the public sector
- Parliamentary support for economic development plans

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Kuwait

National facts	
Type of government	constitutional emirate
Capital	Kuwait
Surface area (thousand sq km)	17.8
Population (millions)	3.5
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	2010	
Economic size	*bn USD*	*% world total*
Nominal GDP	126	0.20
Nominal GDP at PPP	140	0.19
Export value of goods and services	75	0.40
IMF quotum (in mln SDR)	1381	0.64
Economic structure	*2010*	*5-year av.*
Real GDP growth	3.1	4.3
Agriculture (% of GDP)	0	0
Industry (% of GDP)	48	52
Services (% of GDP)	52	48
Standards of living	*USD*	*% world av.*
Nominal GDP per head	35218	357
Nominal GDP per head at PPP	39127	333
Real GDP per head	25847	323

Social and governance indicators	rank / total
Human Development Index (rank)	47 / 169
Ease of doing business (rank)	74 / 183
Economic freedom index (rank)	61 / 179
Corruption perceptions index (rank)	54 / 178
Press freedom index (rank)	87 / 178
Gini index (income distribution)	n.a.
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Japan	14	US	14
South Korea	13	China	9
India	12	Germany	7
US	9	Japan	7
Main export products (%)			
Crude oil			92
Non-oil			8
Main import products (%)			
Intermediate goods			40
Consumer goods			39
Capital goods			21
Openness of the economy			
Export value of G&S (% of GDP)			59
Import value of G&S (% of GDP)			26
Inward FDI (% of GDP)			0.1

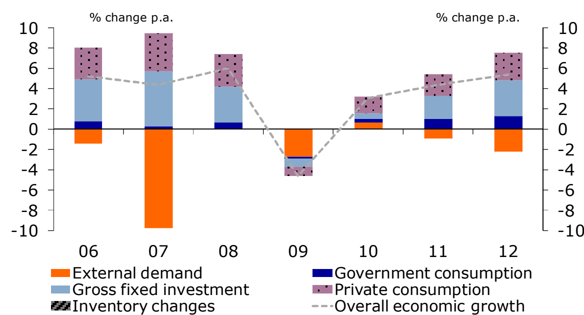
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Kuwait's small economy is undiversified and almost fully based on oil; 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 revenues are oil-related. Structural shortages of water and arable land imply that the prospects for Kuwait's manufacturing and agricultural sectors are extremely limited.

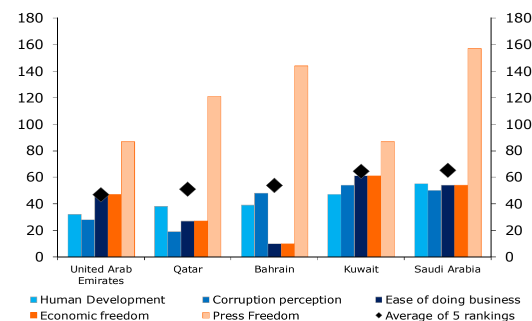
Although a key policy is to increase the number of Kuwaitis working in the private sector, high public sector wages do not stimulate job seeking in the private sector, which employs only 30% of the national labour force. The four-year Development Plan (2010-2014) was approved by parliament in 2010 and 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 2010, with the private and public sectors each providing half of the total funding. But 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 on it is below target, because of the usual disputes between the government and the parliament.

Chart 1: Growth drivers



Source: EIU

Chart 2: Social and governance indicators



Source: EIU

As chart 1 shows, real output is growing by about 4% annually. The sharp real GDP contraction in 2009 (-4.5%) was a consequence of the global economic crisis leading to lower oil production and exports (-11%). The recovery started in 2010 and is projected to continue as world demand for energy increases and the -mostly government financed – gross fixed investments will resume. The non-oil industry is still so small that its impact on the country's overall GDP growth is minimal. The main risk to real growth are lower world oil prices and demand and difficulties in implementing the Development Plan for public investments. Nominal GDP, when corrected for domestic inflation (around 5% annually) and expressed in USD, better reflects the financial resources available to the inhabitants and the government. This available income grew since 2006 by 20% each year (apart from 2009 when it fell by a whopping 30%), driven by steeply rising oil prices.
The global financial crisis revealed vulnerabilities in the Kuwaiti financial sector that had developed during the boom years (2003-2008). Nevertheless, on average, the Kuwaiti banks are highly capitalized, liquid and shielded against foreign exchange risk. Their asset quality improved in 2010 after deteriorating in 2008 and 2009, with the non-performing loan ratio dropping to below 9% (from 11.5% in 2009). The overall capital adequacy ratio (Basel 2) also improved to 19% at end-2010 from below 17% at end-2009.
The loan portfolio remains biased to risky segments: real estate, construction, investment companies and finance for equity purchases account for over 50% of the total loan portfolio. But according to recent stress tests conducted by the IMF (June 2011), even under the most adverse scenario (being a large fall in oil and assets prices), the capital needed for Kuwait banks to restore their capital asset ratio to the 12% requirement would be less than 2% of GDP, a small cost compared with the government reserves available.

Political and social situation

The turmoil in the Arab world had little impact on Kuwait. Some demonstrations took place at the start of 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 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 basis food items until March 2012, together at a cost of 3% of GDP.
Frequent frictions within and between the emir-appointed government and the parliament hamper the legislative process, economic policies and development spending. In April 2011, the

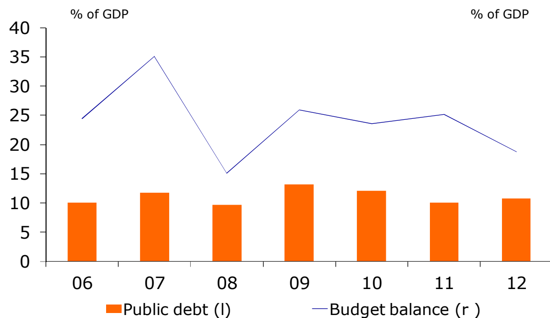
government was forced to resign, but that is not unusual in Kuwait, with the emir appointing a government under the same prime minister. New general elections will be held in 2013, but under the present clan-like constituency system, without prospects for legalization of political parties. This will ensure the continuation of the Al Sabah family style of rule, which foregoes decisiveness while seeking consensus in the family and among the wider elite.
Kuwaiti nationals, who comprise third of the total population of 3.5m, are comparatively wealthy and enjoy comfortable salaries, pensions and welfare allowances, all based on the country's vast oil revenues. The subsidized utilities also benefit the 2.5m non-nationals, but signs of income inequality can be seen in the outskirts of the capital and settlements further away.
The main geopolitical risk in the region is the possible confrontation between Iran and the US, Kuwait's long-standing strategic ally. Relations with Iran were formally restored in May 2011, 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. To gain more regional weight, Kuwait is a committed member of the Gulf Co-operation Council (GCC) and contributed to the GCC forces that intervened during the 2011 uprising in Bahrain. Strong bilateral relationships are sought with China, Japan and India, major destinations of Kuwaiti oil and of Kuwait's outward direct investments. Furthermore, the Kuwait Investment Authority (managing the vast stock of government reserves) is relocating its financial assets from the West towards Asia.

Economic policy

Kuwait's authorities recognize that its economy is lagging behind the Emirates, Bahrain and Qatar on economic and social development indicators (see chart 2). A renewed effort to speed up economic liberalization led to the 2010-14 Kuwait Development Plan. Kuwait's ambition to become a regional trade and financial centre by 2014 is hard to realize as it is also the target of each of the three above-mentioned Gulf States. Early 2010, the much-delayed privatization law was passed and a private sector water and power project went ahead, labor market legislation was passed, which should close the gap between high public sector and lower private sector wages. But actual government spending for the plan stalled later in the year as parliament did not approve of the details of the grand design. Also, liberalization will proceed gradually given internal political and bureaucratic obstacles that delay implementation. Nevertheless, the integration of the economy in the common market, monetary union and other economic initiatives of the Gulf Cooperation Council (GCC) is helpful in somewhat diversifying the economy.
At first glance, Kuwait has very strong public finances. Chart 3 shows that year after year Kuwait continues to realize huge public surpluses in the order of 25% of GDP. Rising world oil price has been a major driver of revenue growth, but current spending on subsidies, social transfers and on investment expenditures have also increased, and faster. As a result, the fiscal surplus in terms of GDP shows a slightly declining trend.
82% of revenues are derived from the oil sector, reflecting the extreme undiversified structure of government finances. Without oil a so-called non-oil fiscal deficit of 56% of non-oil GDP (2010) would emerge, up from 39% in 2002. Incomes from the large public investments are estimated to be around 7% of GDP, implying a return on assets of just over 2% in 2011. Other revenue options (income tax, company taxes, custom duties, telecommunication tax and fines) are being discussed. Only if the price of oil (for 2011 projected at USD 72 per barrel) would drop to below USD 55 per barrel, this would result in a deficit. Although Kuwait's so-called break-even price is rising, it is still comfortably below that of Saudi Arabia (almost USD 80 per barrel) and Abu Dhabi (USD 65), where at times fiscal deficits appear.

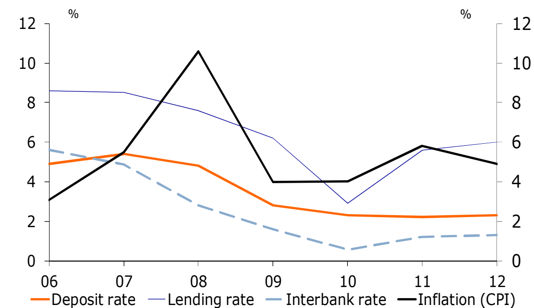
Gross public debt has been stable at the low level of around 10% of GDP and is unlikely to change. Issued and managed by the Central Bank of Kuwait (CBK) it serves to regulate liquidity of the domestic banks, not to finance current or investment spending. On a net basis, the government is a major creditor of USD 300bn or over 225% of GDP (2010). Much of it is invested in liquid securities, thus ready when the oil revenues nosedive or when financial sector needs support. Given the projected surpluses this accumulation of net assets will continue in the years ahead.

Chart 3: Public finances



Source: EIU

Chart 4: Inflation and interest rates

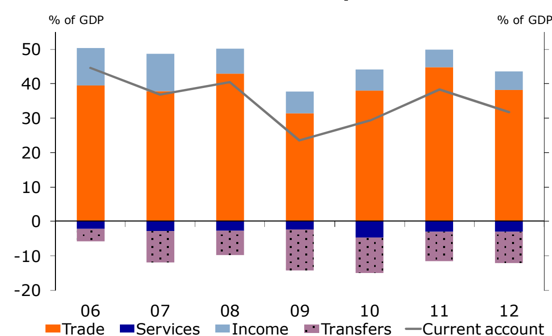


Source: EIU

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 May 2011, 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 continue to feed 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 5% (see chart 4).
Kuwait is strongly in favor of the planned GCC monetary union, but that union encountered political delays and is unlikely to materialize before before 2015.

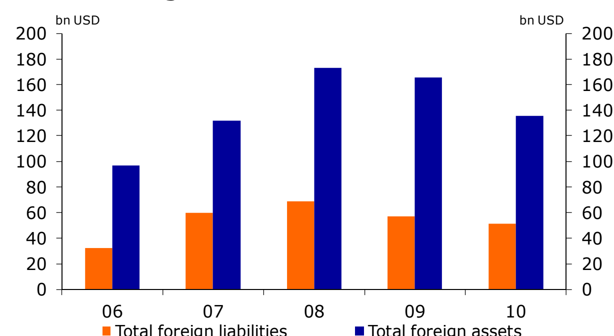
Balance of Payments
Oil accounts for over 90% of merchandise exports value (and almost half of GDP in 2010). High oil prices and steadily growing volumes led to very substantial trade surpluses in the order of 35% of GDP, despite increasing import bills. Lacking an agricultural and industrial base, almost any final product (consumer or investment) is imported. On top of this trade surplus, there are net incomes of around 6% of GDP (see chart 5), that reflect the financial returns of the large (net) sovereign external funds.
On the outflow side, there are net imports of services (4% GDP), and more sizable remittances (10% GDP; transfer balance) made by the 2.5m expatriates to their 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. 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.

Chart 5: Current Account composition



Source: EIU

Chart 6: Foreign assets and liabilities

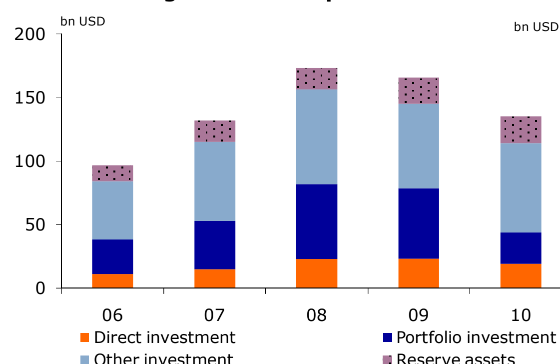


Source: EIU

External position

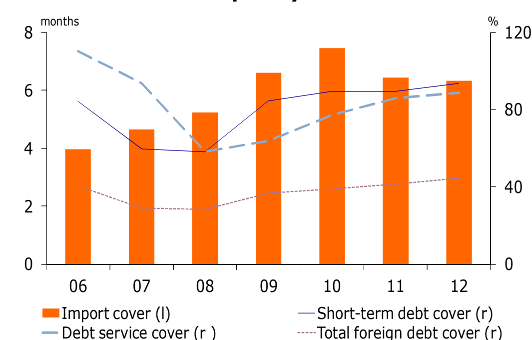
Gross total external debt of USD 55bn (or 43% of GDP in 2010) is much smaller than the USD 135bn of IMF reported gross external assets (chart 6). But, according to Fitch rating agency this is only half of the actual value of total external assets. Fitch estimates the value of the sovereign foreign assets already at over USD 270bn by the end of 2010 or 215% of GDP in that year. A similar estimate is reached using published current account surpluses over the years and global investment indices. Total external assets, including sovereign and private sector held assets abroad, are estimated to be around USD 300bn (240%of GDP). After distracting gross external debt a very strong net foreign assets position of around USD 245bn (200% GDP) remains.

Chart 7: Foreign Assets composition



Source: EIU

Chart 8: External liquidity



Source: EIU

These assets are not without value risk. As chart 7 testifies, financial markets losses during 2009 and 2010 negatively impacted the value of the foreign assets portfolio. The USD 20bn decline in net value of IMF-published foreign assets still 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 6 months of total value of goods and services imports (chart 8), while other external liquidity indicators show stability.

Kuwait	2006	2007	2008	2009	2010	2011e	2012f
GDP in bn USD	101.6	114.6	148.8	109.5	126.1	160.5	159.2
Key country risk indicators							
GDP (% real change pa)	5.2	4.4	6.0	-4.6	3.1	4.4	5.4
Consumer prices (average % change pa)	3.1	5.5	10.6	4.0	4.0	5.8	4.9
Current account balance (% of GDP)	44.6	36.8	40.5	23.5	29.2	37.9	29.9
Total foreign exchange reserves (mln USD)	12566	16660	17113	20268	21237	23518	26560
Economic growth							
GDP (% real change pa)	5.2	4.4	6.0	-4.6	3.1	4.4	5.4
Gross fixed investment (% real change pa)	21.0	24.4	13.0	-3.0	2.0	8.0	12.0
Private consumption (% real change pa)	7.7	9.0	7.4	-2.0	3.5	4.5	6.0
Government consumption (% real change pa)	4.5	1.5	4.0	-1.0	1.5	5.5	7.5
Exports of G&S (% real change pa)	0.3	0.6	8.0	-13.0	2.7	3.9	4.4
Imports of G&S (% real change pa)	4.7	29.5	9.0	-8.4	1.3	6.5	10.0
Economic policy							
Budget balance (% of GDP)	24.4	35.1	15.1	26.0	23.6	25.1	18.8
Public debt (% of GDP)	10	12	10	13	12	10	11
Money market interest rate (%)	5.6	4.9	2.8	1.6	0.6	1.2	1.3
M2 growth (% change pa)	22	19	16	13	3	5	7
Consumer prices (average % change pa)	3.1	5.5	10.6	4.0	4.0	5.8	4.9
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	45311	42176	60243	25782	36816	60810	47600
Trade balance	40213	43409	64005	34398	47903	71216	59610
Export value of goods	56453	62526	86944	51686	66965	93621	85020
Import value of goods	16240	19117	22939	17288	19062	22405	25410
Services balance	-2194	-3175	-3816	-2541	-5899	-4780	-6120
Income balance	10966	12395	10743	6930	7818	8172	8880
Transfer balance	-3674	-10453	-10689	-13006	-13002	-13799	-14780
Net direct investment flows	-8090	-9672	-9097	-7525	-1989	-1427	-1060
Net portfolio investment flows	-29127	-34904	-28129	-8195	-7734	-33835	-25820
Net debt flows	10756	26461	3256	-5378	-689	2328	2760
Other capital flows (negative is flight)	-15146	-19961	-25822	-1534	-25420	-25591	-20450
Change in international reserves	3704	4101	452	3150	984	2286	3040
External position (mln USD)							
Total foreign debt	31145	57736	60608	55231	54542	56870	59630
Short-term debt	14900	27900	29400	24000	23728	26259	28440
Total debt service due, incl. short-term debt	11400	17792	29434	31722	27467	27423	29920
Total foreign exchange reserves	12566	16660	17113	20268	21237	23518	26560
International investment position	64220	71577	104284	108655	84283	n.a.	n.a.
Total assets	96641	131612	172999	165488	135438	n.a.	n.a.
Total liabilities	32421	60035	68715	56833	51155	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	39.6	37.9	43.0	31.4	38.0	44.4	37.4
Current account balance (% of GDP)	44.6	36.8	40.5	23.5	29.2	37.9	29.9
Inward FDI (% of GDP)	0.1	0.1	0.0	1.0	0.1	0.6	0.9
Foreign debt (% of GDP)	31	50	41	50	43	35	37
Foreign debt (% of XGSIT)	40	65	54	77	65	49	55
International investment position (% of GDP)	63	62	70	99	67	n.a.	n.a.
Debt service ratio (% of XGSIT)	15	20	26	44	33	24	27
Interest service ratio incl. arrears (% of XGSIT)	2	3	1	1	1	1	1
FX-reserves import cover (months)	4.0	4.6	5.2	6.6	7.4	6.4	6.3
FX-reserves debt service cover (%)	110	94	58	64	77	86	89
Liquidity ratio	236	194	196	157	175	199	176

Source: EIU

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