

KUWAIT: SELECTED ISSUES



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January 2017

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BUDGET FINANCING OPTIONS AND POTENTIAL MACRO-FINANCIAL IMPLICATIONS¹

With large financial buffers and low debt, Kuwait has substantial room to finance the emerging fiscal deficits. The choice of the financing composition and debt instruments could nonetheless have important macro-financial implications. These should be assessed in the context of a comprehensive asset and liability management framework, with careful consideration of the macro-financial linkages to help minimize potential costs and risks to the overall economy. The financing strategy should be underpinned by sound institutional and legal reforms and geared towards the development of the domestic debt markets. The analysis in this paper suggests that a balanced mix of asset drawdown and borrowing from a diversified investor base (non-residents, domestic banks and non-bank financial institutions) would help mitigate negative implications for the economy and develop the corporate debt market.

A. Introduction

1. Kuwait has not had to borrow to finance the budget for decades. The overall budget balance has been in surplus since the early 1980s, except for a few years that followed the first gulf war and during the 1998/99 oil price slump. The deficits during 1990–95, which resulted from the collapse in oil revenue and increased spending on the war and large reconstruction needs afterward, were financed by drawing assets in the Future Generations Fund (FGF), which lost as much as US\$30 billion of its prewar investment portfolio.² Domestic debt, however, increased as a result of the government issuance of a debt collection bond.³ The debt collection bond amounted to about KD 6.3 billion (increasing public debt to over 200 percent of GDP) and was repaid in annual installments by 2006 (Figure 1). In light of these developments, domestic debt markets have remained underdeveloped.

2. The sharp and sustained decline in oil prices since mid-2014 has led to a deterioration in the fiscal position and emergence of financing needs for the first time since 1998. The overall balance declined from a surplus of over 2.4 percent of GDP in 2014 to a deficit of about 18 percent of GDP (about KD 6 billion) in 2015.⁴ The financing of this deficit has thus far taken place mainly through drawing down assets in the General Reserves Fund (GRF), and to a lesser extent domestic bond issues. With oil prices projected to remain low, the fiscal balance is projected to remain in deficit, and financing needs will remain large in the coming years.

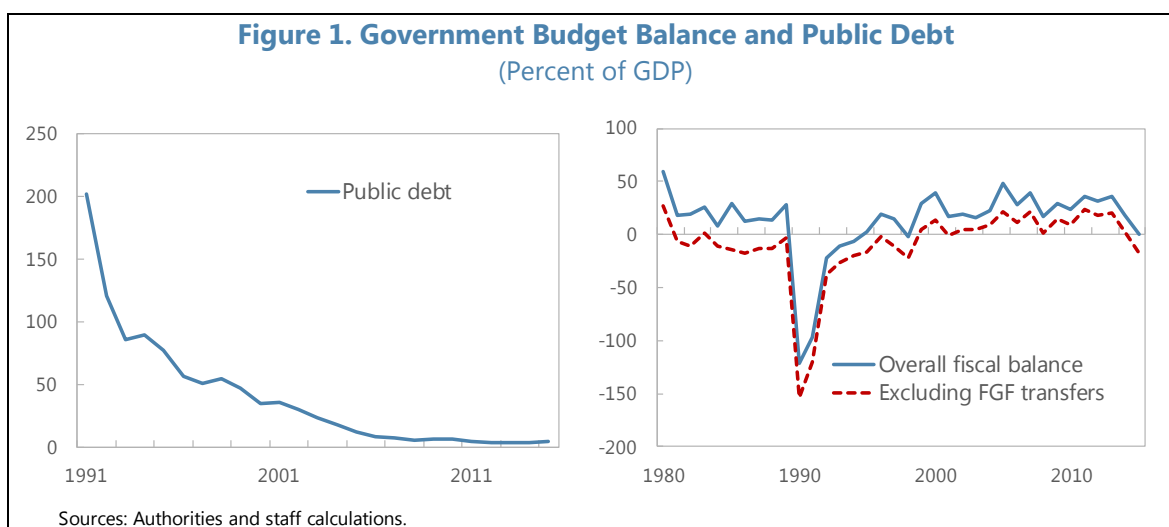
¹ Prepared by Gazi Shbaikat.

² Helem (1993).

³ The bond financed “buy-outs” of nonperforming credits extended by domestic banks and investment companies to Kuwaiti nationals. Asset quality had been impaired during the war.

⁴ The budget balance excludes the 10 percent of total revenue, which by law must be transferred to FGF as well as investment income and profits from state enterprises.

3. Against this background, the government has stepped up domestic issuance, is considering borrowing externally, and is building up capacity in these areas. The government intends to issue debt while it continues to adhere to the fiscal rule of transferring 10 percent of total revenue to the FGF. In this context, borrowing will help limit drawdown of readily available buffers in the GRF. To underpin this financing strategy, the government has started developing its debt management capacity. It has established a high-level debt management committee—which is headed by the undersecretary of the ministry of finance and includes representatives from the central bank and the Kuwait Investment Authority (KIA)—to put in place a comprehensive debt strategy. A debt management unit (DMU), which has been established at the ministry of finance to support the debt committee work, is being operationalized. IMF technical assistance has been provided in this area.



4. The remainder of this paper discusses the various financing options available to the government and related macro-financial linkages, as well as the needed supporting institutional and legal framework. Section B briefly discusses the current institutional and legal framework and the macro-fiscal environment. The benefits and possible costs of the different financing options—drawdown of buffers, domestic and external borrowing—are discussed in the context of an asset and liability management approach (Section C). Section D presents simulations of different financing options and the impact on key economic and financial variables. Sections E and F discuss the investor base and the development of the domestic debt market. The last section concludes and presents policy recommendations.

B. The Institutional and Macro-Fiscal Context

Institutional and Legal Background

5. The government has the legal power to borrow domestically and externally with limits on size and duration set out in the law. Law No. 50 (1987) authorized the government to borrow for 10 years and was subsequently amended by Law No. 3 (1997) to extend the period until 2017.

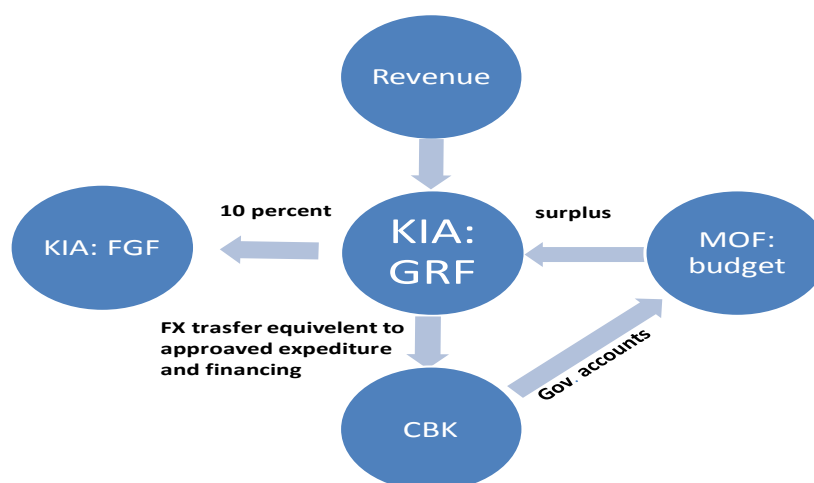
The law sets the following restrictions on borrowing: (a) a debt limit of KD 10 billion; (b) debt issuance maturities of maximum 10 years; and (c) borrowing operations are authorized until 2017. Foreign borrowing is allowed by the Ministerial Decree No 21 of 2009 which sets a limit to the equivalent of KD 5 billion. More recently, the Ministerial Decree No. 63 of 2015 authorized both the CBK and the KIA to carry out borrowing on behalf of the ministry of finance—the CBK for domestic debt operations and KIA for external borrowing in international markets. A draft law is being prepared to follow up on the debt committee recommendations to raise the ceiling to KD 25 billion, extend the debt period out to 2027, and allow bond maturities of up to 30 years.

6. There are other legal and regulatory challenges for government borrowing that need to be addressed. The issuance of sukuk is still hindered by the lack of the needed legal framework. The issuance of sukuk Al-Ijara, the most commonly used Islamic instrument for sovereign debt, requires underlying assets as collateral and for a revenue stream. Currently, the constitution prohibits the use of public properties as collateral. One other constraint is the Capital Market Authority law which dictates that all public and private issuers need permission from the CMA for their capital market operations. While the CMA bylaws give flexibility to exempt the government bonds under a special agreement with the government, this deviates from the common rule in most countries that explicitly exempts sovereign issuers from this type of requirement.

7. The KIA has crucial budgetary linkages and a central role in the financing process (Figure 2). The agency conducts investment and fiscal agent functions through its two main funds, the FGF and the GRF (Box 1). It is also in charge of external borrowing on behalf of the government. By law, the FGF has been receiving a minimum of 10 percent of total revenue every year since 1976. The accumulated stock is invested abroad in long term financial and real investments. No withdrawal is allowed from the FGF, including its investment income, unless sanctioned by law. The budget surpluses recorded up to recently have been retained by the KIA in the GRF. The GRF assets are mostly invested in cash and cash assets and, to a lesser extent, government shares in public enterprises. The GRF can be used to finance the government deficits, as has been the case since 2015. Information on the size of KIA assets and their allocation (including the split between the FGF and the GRF) is not publicly available. Staff, however, estimates that total assets of the KIA amounted to about \$530 billion by end-2015, broadly divided as two thirds/one third in the FGF and the GRF, respectively.

8. The government's treasury and cash management operations are conducted through the GRF. All government revenues are first deposited in the GRF, which then allocates these revenues to the FGF (the 10 percent) and pays out government expenditure in amounts specified in the budget law. The KIA projects and manages cash outflows, which are channeled to the treasury single account at the CBK and the various governmental sub-accounts of line ministries and other agencies.

Figure 2. Financing Linkages



Box 1. The Kuwait Investment Authority

The KIA was established in 1982 as an independent government body managed by a board of directors headed by the minister of finance. It is charged with saving and investing unspent government revenue in two separate funds, the Future Generations Fund (FGF) and the General Reserves Fund (GRF).

The GRF is the treasurer as well as the stabilization fund managed by the KIA. It was established in 1952 and was managed prior to the creation of the KIA by the London-based Kuwait Investment Office. The GRF is the repository of the annual state's revenues, the accumulated past surpluses, and retained investment income. Budget expenditures are paid out of the GRF as stated in the budget law. The GRF consists of investments in Kuwait and other MENA countries as well as hard currency assets held by KIA on behalf of the State of Kuwait. The GRF also holds other government assets, including Kuwait's participation in public enterprises such as the Kuwait Fund for Arab Economic Development and Kuwait Petroleum Company in addition to Kuwait's participation in multilateral and international organizations. About 80 percent of the GRF assets are liquid cash and cash assets according to the authorities.

The FGF is the intergenerational saving platform managed by the KIA. It was established in 1976 by an Emiri decree, which mandated a transfer of 50 percent of the assets held in the GRF then to the FGF, and an annual transfer of 10 percent of every year's budget revenue starting from the 1976/77 budget. The decree stated that investment income on these assets shall be retained by the FGF and no assets can be withdrawn from the FGF unless sanctioned by law. The FGF is a long term investor in various asset classes ranging from more traditional assets such as equities and bonds to alternatives such as private equity, real estate and infrastructure. All the FGF investments are abroad.

The government has consistently adhered to this fiscal rule and the only exception to the transfer rule was during the period 2011–13 when the parliament increased the annual transfer to 25 percent instead of 10 percent. And the only exception for using resources in the FGF was the withdrawal of funds during the Iraqi invasion and occupation in 1990/1991 where funds were withdrawn to pay for the cost of liberation and subsequent reconstruction. Nearly \$85 billion were withdrawn from the FGF during the period 1990 until 1994. In any event, all amounts of funds which were withdrawn were fully repaid to the FGF (Kuwait Investment Authority 2016).

Source: Kuwait Investment Authority

9. The cash outflow from the KIA is an important source of foreign exchange for the Central Bank of Kuwait (CBK). Payments of expenditure out of the GRF are done through transfers of funds denominated in foreign currency from the KIA accounts to the CBK accounts abroad, i.e. the KIA sells foreign exchange to the central bank which transfers local currency to the government. The size of the transfers is determined by the approved government expenditure envelope and any financing from the GRF in case of revenue shortfalls. Given the large size of government spending in the economy, these transfers are an important source of foreign exchange for the CBK.

The Fiscal Position and Financing Needs Under Different Scenarios

10. IMF staff projects that the fiscal position will improve over the medium term but financing needs will remain large. Kuwait's public finances are largely dependent on oil prices, which IMF staff projects will increase very gradually over the medium term (to reach about \$60 by 2021). In addition, the government has started fiscal reforms to adjust to this new environment by curtailing growth in spending, including through the partial removal of fuel and electricity subsidies. Taking these reforms into account and the projected oil prices, staff estimate that the budget will post a deficit of over 17 percent of GDP in 2016/17 and stabilizes around 13 percent over the medium term (Table 1, first panel).

11. The government's readily available buffers (GRF assets) would decline under staff's baseline projections, and even more so under a negative oil price shock. Under the October 2016 WEO oil prices, the financing needs will amount to about KD 34 billion. Assuming about KD 15 billion will be financed through domestic and external borrowing, the decline in the GRF assets will be the remainder of the financing, KD18 billion (see accompanying staff report). As a share of GDP, the buffer in the GRF will drop from about 145 percent in 2015 to 77 percent by 2021. The overall buffer including the assets in the FGF will, however, increase in nominal term given the surpluses in the underlying overall fiscal balance⁵. If oil prices were to be lower than the WEO projections by 25 percent (about \$10 dollars less), the underlying budget balance would be negative, the fiscal balance under the government definition would record larger deficits, and the gross financing needs during 2016-21 would amount to KD 54 billion (\$180 billion). This size of financing would be larger than the staff's estimate of assets in the GRF, implying that the net fiscal buffer (GRF-debt) would become negative by 2021. Importantly, while the overall buffer including the FGF will remain large (above 340 percent of GDP), it would decline in nominal term under this scenario (Table 1, second panel).

12. Further fiscal adjustment would help reduce the financing needs and the budget vulnerability to oil price shocks. Under a gradual adjustment path consistent with the implementation of the authorities' planned reforms to bolster nonoil revenue (VAT and corporate income tax) and a gradual reduction in government spending to about 80 percent of nonoil GDP by 2021—a level consistent with that experienced during 2000–10, when oil prices averaged about \$50 per barrel (see accompanying staff report for further details)—the fiscal deficit would be

⁵ The underlying overall fiscal balance includes investment income on KIA assets as part of government revenue and is calculated before the transfers to the FGF. A surplus in this balance means that net transfers to the KIA (the transfer of 10 percent of total revenue to the FGF and transfer to/from the GRF) is positive, increasing total KIA assets.

reduced to about 3½ percent of GDP and the financing needs to about KD 26 billion over the period 2016–21 (Table 1, third panel). Under a lower price shock, the financing needs would increase to KD 48 billion, which will be less than the balance in the GRF, allowing the government to maintain a positive net usable buffer and increase the stock of the KIA assets (Table 1, bottom panel).

Table 1. Financing Needs Under Different Scenarios

	2015	2016	2017	2018	2019	2020	2021	Cumulative 2016-21
	(Percent of GDP)							
	<i>Scenario I: Baseline under WEO oil prices</i>							
Overall balance	0.0	0.7	5.0	5.2	4.5	3.8	2.5	
Actual balance (excluding inv. income and 10 percent of revenue)	-17.5	-17.3	-12.6	-11.7	-12.0	-12.1	-12.8	
Gross financing in KD billion	6.0	6.0	4.9	4.9	5.4	5.8	6.5	33.5
Total government debt	4.7	12.0	18.2	23.0	26.3	29.1	31.8	
Total buffer by the KIA	461.6	479.7	433.1	410.5	391.1	370.7	351.8	
of which GRF assets	144.3	144.9	125.1	112.4	100.6	88.6	76.8	
Memo item: oil price (fiscal year)	49.9	45.9	52.5	54.8	56.3	58.2	59.3	
	<i>Scenario II: Baseline under lower oil prices</i>							
Overall balance	0.0	-2.2	-6.3	-6.3	-7.1	-7.9	-9.3	
Actual balance (excluding inv. income and 10 percent of revenue)	-17.5	-20.3	-24.2	-23.1	-23.2	-23.1	-23.5	
Gross financing in KD billion	6.0	6.9	8.4	8.6	9.3	9.9	10.8	53.9
Total government debt	4.7	12.6	22.2	29.0	33.9	38.1	42.0	
Total buffer by the KIA	461.7	477.1	471.4	435.1	402.3	369.3	338.5	
of which GRF assets	144.3	142.5	127.6	103.8	81.3	59.3	38.2	
Memo item: oil price (fiscal year)	49.9	42.7	39.5	41.2	42.4	43.8	44.6	
	<i>Scenario III: Adjustment under WEO prices</i>							
Overall balance	0.0	1.2	6.3	6.5	7.9	9.1	9.4	
Actual balance (excluding inv. income and 10 percent of revenue)	-17.5	-16.8	-11.4	-10.7	-9.0	-7.7	-6.9	
Gross financing in KD billion	6.0	5.9	4.4	4.4	4.0	3.6	3.5	25.8
Total government debt	4.7	11.8	17.9	22.7	25.8	28.2	30.4	
Total buffer by the KIA	461.6	480.2	436.0	415.3	401.4	387.6	376.2	
of which GRF assets	144.2	145.3	127.1	115.7	107.4	100.3	94.6	
Memo item: oil price (fiscal year)	49.9	45.9	52.5	54.8	56.3	58.2	59.3	
	<i>Scenario IV: Adjustment under lower oil prices</i>							
Overall balance	35.5	18.5	0.0	-1.7	-4.7	-4.7	-3.4	
Actual balance (excluding inv. income and 10 percent of revenue)	20.0	2.4	-17.5	-19.8	-22.7	-21.8	-19.9	
Gross financing in KD billion	6.0	6.7	7.8	8.1	7.9	7.8	7.8	46.1
Total government debt	4.7	12.4	22.0	28.6	33.3	37.2	40.6	
Total buffer by the KIA	461.7	477.6	475.0	441.2	414.4	388.6	365.7	
of which GRF assets	103.5	114.4	139.7	130.6	108.2	79.3	55.9	
Memo item: oil price (fiscal year)	49.9	42.7	39.5	41.2	42.4	43.8	44.6	

Sources: Country authorities, and staff calculations.

C. Financing Options: General Considerations

Asset and Liability Management Framework

13. Addressing the financing issue in the context of a comprehensive asset and liability management (ALM) framework is important. As they stand, the authorities' plans entail a combination of (i) domestic and external borrowing; (ii) a drawdown of GRF assets; and (iii) continued mandatory transfers to the FGF to be invested in higher-yielding assets. At the moment, higher returns on FGF assets, low borrowing costs, and the need to develop debt markets provide support for this approach. Over time, the government would benefit from assessing the

costs and benefits of the various borrowing and investment options in the context of a comprehensive ALM framework, where financing policies are restated based on the whole country balance sheet with a view to minimizing costs and risks for the overall economy. This involves not only basing decisions on cost of borrowing versus return on assets, but also the financial characteristics of sovereign assets and liabilities to ensure there are no mismatches that could expose the country as a whole to a wide range of risks, including interest rate and exchange rate risks (IMF 2014). Many governments apply a partial ALM approach, in which several elements of the sovereign balance sheet are considered simultaneously, even in the absence of a comprehensive or formal framework.

14. In the case of Kuwait, a sovereign balance sheet can be usefully constructed for analytical purposes. In addition to the buffers in the GRF and the FGF, which could be used under emergency situations, the sovereign wealth includes (i) government deposits in the banking system (ii) the stakes in public enterprises, a number of which such as the national airlines and some downstream activities and services in the oil sectors are under consideration in the privatization plan, (iii) the foreign exchange reserves of the central bank, (iv) the pension fund assets, and, in a broader definition of the government net worth, (v) the value of underground oil resources. On the liabilities side, the balance sheet should include the government domestic and external debt as well as central bank liabilities and any unfunded pension schemes and future contingent liabilities.

15. Applying an ALM framework in Kuwait requires institutionalizing new arrangements for coordination among the concerned institutions. Currently, coordination takes place regarding investment and borrowing decisions, but in a somewhat separated way. The membership of the ministry of finance and the CBK in the KIA board ensures high level oversight of KIA investments. Similarly, KIA and CBK are represented at the debt management committee. Nonetheless, the authorities would benefit from strengthened and more integrated asset and liability management. In particular, this should be supported by formalizing arrangements at the operational level. This includes sharing information, aligning asset allocation strategies with the debt characteristics (for instance currency composition and duration), and better coordinating cash and debt management between the MOF, KIA, and CBK.

16. The government would benefit from increased disclosure of its assets and transparency in the presentation of its fiscal accounts. Dissemination of data on government assets would be all the more important as the government seeks to access global markets and steps up debt issuance. As discussed above, an effective AML framework requires increased information sharing among a broader group of agencies. Transparency under this collaborative framework would help promote accountability and discipline, thereby improving the decision making process. Moreover, in line with best practices, integrating the GRF and public debt operations into the budget process would enhance transparency and clarify linkages with the KIA. Currently, the KIA, retains investment incomes (as per the law) and settles interest payments on public debt with the CBK from the GRF accounts. For more transparent presentation of the fiscal accounts, investment income on the GRF and the FGF should be recorded above the line as revenue and interest payments as expenditure. The fiscal accounts should also record transfers to and from the KIA as financing items.

Borrowing vs. Drawing Down Buffers

17. From an ALM perspective, the choice between issuing debt and running down buffers is a balance sheet optimization issue. While the net position of the general government may not be affected by the financing mix, more reliance on borrowing will expand the size of the balance sheet (higher assets by the KIA with higher debt liability on the government side). By the same token, using the buffer will shrink the balance sheet (reduction of the KIA foreign assets). Expanding the balance sheet will provide more resources and flexibility in the execution of fiscal policy but creates higher exchange rate, interest rate, and refinancing risks. The tradeoffs can also be viewed from a self-insurance perspective, in which higher expected borrowing costs can be seen as an insurance premium against adverse liquidity events. In this way, the analysis of optimal borrowing strategies is closely linked to other insurance and risk factors related to the sovereign balance sheet (IMF 2014). Finally, over time, this type of optimization may also imply that a different percentage of revenues should be transferred to the FGF to be invested in less liquid, higher yielding assets.

18. The relative cost of borrowing versus return on KIA assets is a key consideration but deciding on the appropriate composition of financing should be guided by a broader set of factors. These include the initial balance sheet position, macroeconomic conditions, global financing terms and market appetite, degree of domestic financial market development, and institutional capacity, including of managing debt. As a heavily oil-dependent country, oil revenue uncertainty and volatility should also factor in the decision of financing. The debt management strategy should address these elements and explain why the government is borrowing while it maintains a substantial portfolio of assets.

19. Broadly speaking, the current circumstances may justify borrowing while financial buffers are still large. The low debt level and favorable domestic and global environment should encourage the authorities to focus on borrowing to finance the deficit. Waiting until the liquid buffers are run down first, may lead to a deterioration in credit worthiness in the eyes of rating agencies and investors and could coincide with tightening global financing environment (i.e., it may be best to use buffers when global markets become less accessible and borrowing becomes more expensive). This insurance motive is important in view of the susceptibility of the fiscal position to oil revenue volatility. Mixing borrowing with the use of the buffer, and perhaps with a larger proportion of the latter in the coming months, is however inevitable given the large and sudden increase in financing needs and the time needed to build capital market access across different instruments and building institutional capacity to manage debt.

20. With potentially less foreign exchange inflows backing government spending, coordinating with CBK to ensure adequate central bank reserves is important. Under the current set up, there is no formal arrangement whereby assets in the KIA can be used for contingent support of CBK reserves if needed. This was less of an issue in the past given that government spending was fully and automatically covered by transfers from the GRF to the CBK—the CBK has in the past resorted to the KIA for foreign exchange support on ad hoc basis. Formalizing a policy for this support may be warranted in the new environment of lower oil prices and increased reliance on debt financing. Clear supporting rules and procedures for this policy would further address this risk

and promote transparency and accountability of the KIA. Some countries, like Botswana and Korea, set up guideline for assets in SWF to be used for balance of payments support (see IMF 2014 for further discussion on management of sovereign assets and central bank reserves).

21. Kuwait has thus far lagged behind other GCC countries in debt issuance. Financing in 2015/16 relied exclusively on the use of resources in the GRF, while domestic debt issuance has been ramped up in recent months. No external borrowing has taken place so far, although preparation is underway to issue up to \$10 billion in the international market. In the other GCC countries, the use of buffers covered about 80 percent of the financing needs and the rest was secured through borrowing in 2015. All the other GCC countries have indeed already issued bonds and/or obtained syndicated loans in international markets since 2015 (Table 2).

Domestic Versus External Borrowing

22. Domestic borrowing provides a currency-risk free and more stable financing source, compared to external borrowing. Relying on the more stable domestic investor base would help reduce debt rollover risks and volatility. External borrowing, on the other hand, increases exposure to sudden shifts in investor sentiment which could cause abrupt capital outflow and greater volatility. In addition, external debt is subject to exchange rate risk, which in the case of Kuwait will depend on the currency composition of the debt and its alignment with the basket of currencies to which the Kuwaiti dinar is pegged. However, the exchange rate risk is mitigated by the fact that most government revenue is from oil receipts denominated in US dollars, which represents the largest share in the exchange rate basket.

23. Developing the domestic capital market is a key factor favoring reliance on domestic borrowing. Issuance of domestic bonds presents a new opportunity for investment and asset diversification in the financial sector. Currently, banks hold a small proportion of their assets in short-term CBK bonds and government treasury bonds. The pension fund and other potential institutional investors could also benefit from the existence of a market for long-term government bonds. Establishing a risk-free government yield curve would also help develop the private debt market. This in turn would help strengthen private sector development, economic diversification, growth, and resilience of the economy to shocks.

Table 2. GCC—Sovereign Bond Issuance and Syndicated Loans, 2015–16^{1/}

	S&P Ratings	Amount Issued (US\$ billion)	
		International	
		2015	2016
Bahrain	BB	1.5	0.6
Kuwait	AA	0.0	0.0
Oman	BBB-	0.0	5.5
Qatar	AA	5.5	9.0
Saudi Arabia	A-	0.0	27.5
United Arab Emirates	AA	0.0	5.0

Sources: Bloomberg; Haver; and IMF staff estimates.

^{1/} International issuance is as of Oct, 2016.

24. Excessive domestic borrowing could, however, crowd-out private sector credit and adversely affect growth. More holding of government debt instruments could reduce the supply of loanable funds, increase real interest rates, and ultimately reduce private sector investment and growth. However, banks could accommodate the larger holding of government debt instruments without much crowding out, for instance, through substitution with other asset holdings or by expanding their balance sheets by raising more deposits or borrowing externally (two banks have issued bonds in global markets so far this year). Even if some crowding out of bank financing took place, investment may not be affected or the impact can be mitigated if the private sector access to financing in the corporate bond market increases as a result of the reforms and development of the public debt market.

25. Global markets could provide better terms and greater scope for borrowing than domestic markets. The global financing environment remains favorable for now, and Kuwait has a very strong credit rating (AA). The GCC countries with similar rating (Qatar and UAE) have accessed international markets at better terms than their domestic borrowing. Qatar, for example, issued a 5-year domestic bond in August at a yield 60 basis points higher than the yield on its 5-year Eurobond (IMF 2016). International markets have also greater absorptive capacity to meet Kuwait's large financing needs projected this year and over the medium term. This would alleviate pressures on the domestic market and minimize adverse implications of government debt financing on the private sector. However, the cost of funding externally would likely rise over time and access could become more difficult especially as the U.S. Federal Reserve gradually normalizes its policy rates and oil and commodity producing countries turn to the international market for additional financing.

26. External borrowing would be a preferred option from the CBK reserves view point. Assuming the foreign exchange receipts are channeled to the CBK, external borrowing would be a substitute for the GRF financing in terms of supplying the CBK with foreign exchange.⁶ Domestic borrowing on the other hand would result in less direct inflows of foreign exchange to back government spending, with the net final impact depending on the dynamics of other factors affecting the CBK reserves. For instance, repatriation of foreign assets by banks and government agencies (or less outflow for investment abroad) to accommodate more investment in government instruments would support the CBK reserves. A tightening in domestic liquidity and higher interest rates in response to domestic bond issuance could also reduce demand for foreign exchange.

Macroeconomic Policy Considerations

27. The policy response to ensure macroeconomic stability will depend on the financing options. Larger reliance on domestic financing compared to external borrowing or drawing down buffers could lead to upward pressures on domestic interest rates and lower aggregate demand and inflationary pressures. The policy response could include measures to support banks' liquidity, for instance through shifting some of the public enterprises' financial investments abroad to the domestic banking system, and, over the medium term, through financial reforms to increase

⁶ It is not clear whether this is going to be the case given that external borrowing is charged to the KIA on behalf of the government.

financial deepening. The authorities could also use macroprudential limits, if appropriate. For example, Oman recently changed the measurement of the reserve requirement to allow government securities and increased the maximum holding limit to 45 percent of net worth. It also reduced the maximum permitted exposure to foreign assets by half. Note that any such changes would need to consider the subsequent impact on other risk exposures to determine whether they are appropriate or not (see IMF Regional and Economic Outlook for the Middle East and Central Asia, October 2016).

28. Drawing down buffers and external borrowing have similar direct macroeconomic implications to those of oil revenue inflow. They all represent externally originated inflows to finance domestic spending. As long as the choice of financing does not lead to additional spending or change the nature of spending, external financing affects the domestic economy in the same way as oil revenue inflow. If anything, external borrowing or drawing down assets is expected to be associated with more fiscal discipline and encourage fiscal reforms and therefore is expected to create less Dutch-disease type pressures.⁷ Given the rationalization of expenditure initiated by the government and planned over the medium term, and the well-established peg of the dinar to a basket of currencies, these inflows are not expected to create nominal exchange rate pressures and should not affect inflation and lead to real exchange rate appreciation.

29. The new financing environment may entail changes in monetary policy operations. Currently, the CBK manages the issuance of government bonds as well as that of its own instruments (bonds and Tawarruq—a commodity based Islamic product) to manage liquidity of conventional and Islamic banks. Going forward, with larger debt issuance, monetary operations and the debt strategy should be closely coordinated to ensure effective liquidity management and minimum financing costs. This should involve coordinating the amount of bank liquidity to be absorbed by government and CBK bonds (for instance by inviting non-bank investor to participate in the auctions), the maturity of these instruments (the CBK issues instruments with relatively short maturity, while the government finances itself at longer maturity), and their yield structure. An alternative approach, followed in a number of countries, such as Brazil, is to centralize debt issuance with the government and use treasury instruments for liquidity management (IMF 2014).

30. Larger bank holdings of government debt instruments would affect the structure of banks' assets and liabilities and could have macroprudential implications. Basel liquidity regulations require banks to hold sufficient amounts of high-quality liquid assets to cover their net cash outflows for a period in a stress scenario. Greater supply of government bonds would therefore increase the options for banks to manage their balance sheets in compliance with regulatory requirements. Excess liquidity will not be sufficient to absorb the additional bonds, and banks will likely reduce other asset holdings, including their large foreign exposure through subsidiaries and

⁷ The impact of external inflow will depend on how these inflows are spent and absorbed. If they are used to finance additional spending and are absorbed through higher imports, the current account would widen with marginal impact on inflation. If external borrowing is spent but not fully absorbed (the current account does not widen), inflationary pressure could rise unless the reserve accumulation is sterilized, IMF (2012).

branches abroad.⁸ While reducing exposure abroad will reduce foreign exchange risk, more domestic investments may increase market risk with less diversification of portfolio and earnings.

D. The Appropriate Financing Mix: Results from a Simulation Exercise

31. What are the implications of the different financing combinations? In this section, key macro-financial implications of the various financing options discussed above are simulated, particularly the impact on banks' and nonbanks' asset allocations, private sector credit, domestic liquidity, and central bank reserves. To this end, four different financing scenarios are considered based on different weights given to external versus domestic and bank versus non-bank financing.⁹ One scenario looks at the financing implications under lower oil price assumption. The cumulative budget financing needs for 2016–21 are estimated at around KD34 billion (\$100 billion) in the baseline oil price scenario— using projections in the October 2016 World Economic Outlook (WEO), and KD54 billion (\$180 billion) under lower oil price assumption (if prices were to be 25 percent below WEO projections), Table 3.

	Banks	Nonbanks	External	Buffer	Total
Scenario I	5.3	1.7	6.9	20.6	34.5
Scenario II	13.8	1.7	6.9	12.1	34.5
Scenario III	8.6	8.6	6.9	10.4	34.5
Scenario IV (Scenario III with lower oil price)	13.6	13.6	6.9	20.2	54.2

Source: staff calculations

Assumptions

- Banks:** The overall balance sheet is assumed to grow in line with customer deposits, which represent the majority of liabilities, at an annual rate of 5 percent on average during 2016–21. Deposits growth will be lower if non-banks participate in the auction for government bonds. Foreign liabilities are assumed to grow in line with previous years, adjusted for changes in nominal GDP growth. Other domestic liabilities are projected to grow moderately. The capital ratio remains 17 percent of risk-weighted assets (comfortably above the 12 percent implicit threshold). On the asset side, cash and current deposits at the CBK are assumed to grow in line with nominal GDP growth, while other reserves at the CBK (time deposits) are assumed to be partly used for buying government bonds, and the central bank bond is assumed to be gradually phased out. While Kuwait has no reserve requirements, the analysis assumes bank reserves at the CBK remain no less than 10 percent of total KD deposits (about 7 percent of total assets). Foreign assets decline moderately as banks allocate more funds to domestic assets.

⁸ At end 2014, one third of total assets abroad is related to loans in other GCC countries, 46 percent of which were in Bahrain, while only 26 percent of total gross loans were in foreign currencies and were covered by strict forex limits.

⁹ The scenario analysis uses a template from recent IMF staff work on Saudi Arabia, see Selected Issues Paper 2016.

Credit to the private sector is calculated as a residual so as to assess the crowding out of different sizes of banks financing of the government deficit.

- **Nonbanks:** The analysis considers the Public Institution for Social Security (PIFSS) and conventional and the Sharia-compliant investment companies (ICs) as potential buyers of government bonds. Both the PIFSS and the ICs assets are projected to grow by 5 percent annually during 2016-21. Currently, the ICs and the PIFSS do not hold government papers among their assets. Holdings of government papers are assumed to be accommodated largely through lower investments abroad (80 percent), and some reduction in their deposits in the banking system (20 percent). PIFSS assets are collected from different issues of the “World’s Largest 300 Pension Funds” by Watson Wyatt. ICs balance sheets are obtained from CBK’s website.

Scenario Analysis

The Four sets of simulations yield the following results (Figures 3 and 4):

- **Scenario I (large reliance on external financing: buffer drawdown and external borrowing):** The scenario assumes around 80 percent of the financing needs will be secured by drawing down assets in the GRF (60 percent) and from external borrowing (20 percent). The remaining financing of 20 percent is divided between banks (15 percent) and non-banks (5 percent). Under this scenario, which is in line with the baseline scenario in the accompanying staff report, banks use excess liquidity and reallocate some liquid assets abroad to hold the additional bonds, which will increase to about 10 percent of total assets by 2021. Banks’ reserves at the CBK as a share of deposits decline, but remains above 10 percent. Credit to the private sector remains strong, growing by over 8 percent annually on average during 2016-21. This leads to a continuation of the recent upward trend in the loan-to-deposit (LTD) ratio which increases to 0.96, but remains below its historical high in 2007 at 1.07. Non-bank institutions are assumed to absorb a small proportion of the bond issuance, representing only 1 percent of their total assets. The central bank’s foreign reserves increase over the medium term supported by drawdowns of GRF assets and external borrowing. Public debt increases to over 30 percent of GDP and the readily available buffers in the GRF decline to some 68 percent of GDP (Figure 3, blue dotted lines).
- **Scenario II (more reliance on banks and less on use of the buffer):** Banks’ absorption of bonds rises to 40 percent of total government financing needs, consistent with what is envisaged by the government for 2016, but assuming this is the plan for the medium term. Nonbanks’ holdings of government bonds and external borrowing are the same as in scenario I (5 percent and 20 percent, respectively). The larger borrowing from banks reduces the need to use the buffer which is assumed to cover only 35 percent of the total financing needs. Under this scenario, banks’ reserves at the CBK decline but remain above 7 percent of total deposits; banks’ foreign assets decline further compared to scenario I to make room for increased purchases of domestic bonds. Credit to the private sector grows on average by 6.1 percent annually during 2016-21, about 2 percentage points lower than scenario I. This leads to a decline in the LTD ratio to 0.85. With less transfer of foreign assets from the KIA to the CBK, compared to scenario I, the

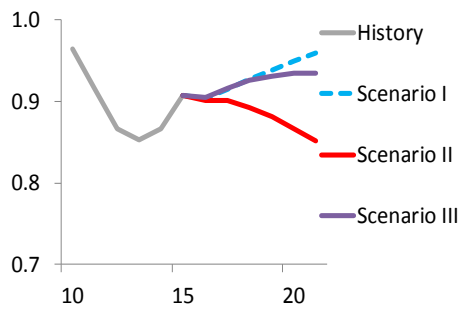
CBK foreign reserves are lower than the baseline level, although continue to grow over the medium term.¹⁰ While debt increases to 43 percent, the buffer in the GRF ends up at a higher level (over 87 percent of GDP, by 2021; Figure 3, redlines).

- **Scenario III (more reliance on nonbanks):** Non-bank institutions absorb 25 percent of government financing needs, reducing the banks' share to 25 percent. Assuming a nonresidents' share at the same level as the previous scenarios (20 percent), drawdown of assets is limited to 30 percent, slightly lower than scenario II. This balanced mix of financing reduces pressures on banks domestic liquidity. Credit growth remains robust, averaging about 7.5 percent annually during the forecast period. Under this scenario, the central bank reserves are projected to be slightly better than scenario II assuming the ICs and the pension fund, which invests most of their assets abroad, repatriates part of these assets to build their domestic portfolio of government bonds (bonds will represent about 22 percent of their total assets by 2021). Government debt is largest under this scenario, reaching over 50 percent of GDP while the buffer remains over 90 percent of GDP by 2021 as in scenario II (note that the net buffer will decline by same amount under the three scenario, from 137 to about 40 percent of GDP by 2021), (Figure 3, purple lines).
- **Scenario IV (lower oil price shock with scenario III):** Oil prices are 25 percent lower than the baseline projections. Assuming unchanged fiscal policy, this would increase the financing needs to about KD 53 billion, from 34 under the above scenarios (Table 3). This worsens the outcomes under the balanced financing mix in scenario III above (see Figure 4, solid and dotted lines): credit growth declines to 5.3 percent, central banks reserves are lower by over KD 1 billion, and the GRF buffer declines to 70 percent compared to 90 percent without the shock, and debt increases to about 70 percent of GDP. The net buffer (GRF-debt), becomes slightly negative by 2021. Banks and non-banks holdings of government bonds represent a significant share of their total assets, 18 percent and 34 percent, respectively, (Figure 4 dotted lines).

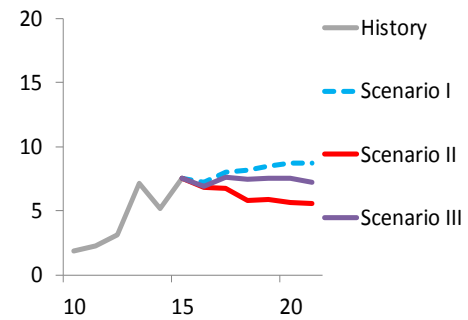
¹⁰ Estimate of the decline in the CBK reserves takes into account the positive impact on reserves from the repatriation foreign assets by banks and nonbanks and from lower liquidity and private sector credit growth.

Figure 3. Key Indicators: Scenarios I-IV

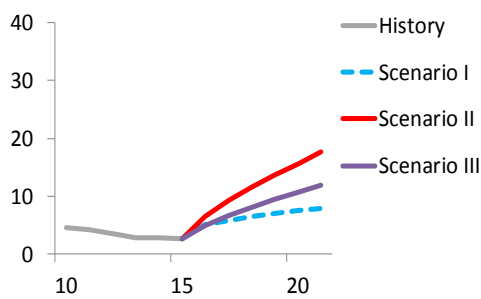
Loan to deposit ratio



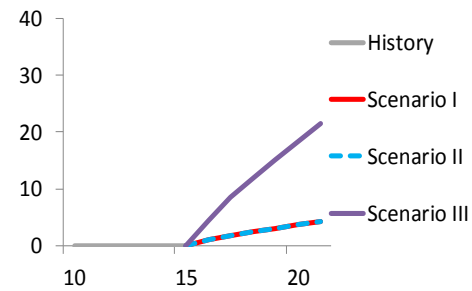
Private sector credit growth (% yoy)



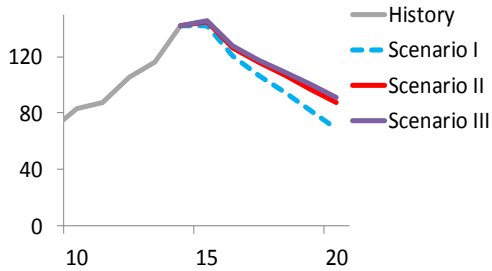
Bank holdings of gov. bonds (% of assets)



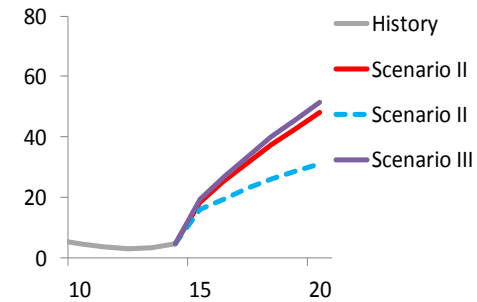
Non-banks holdings of gov. bonds (% of assets)



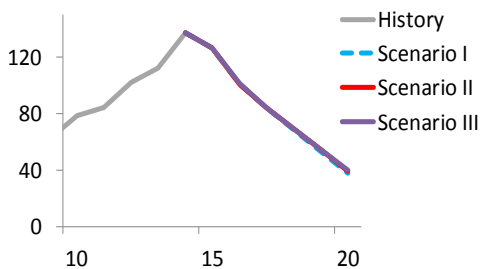
Buffer (% of GDP)



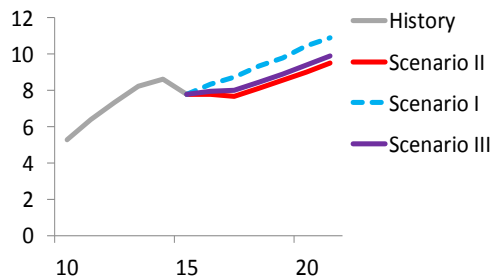
Debt (% of GDP)



Net buffer (% GDP)



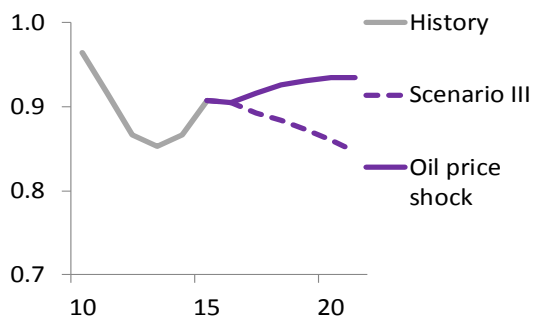
Central Bank Reserves (KD billion)



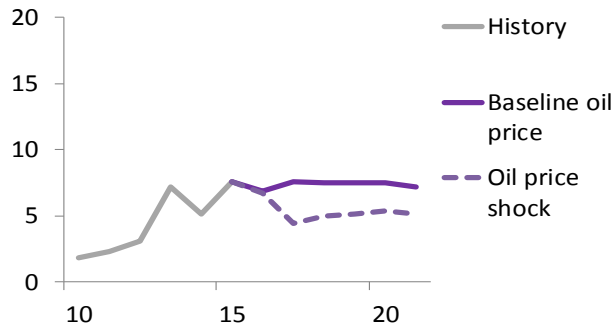
Source: IMF staff calculations.

Figure 4. Key Indicators: Scenario III Under Baseline and Oil Price Shock

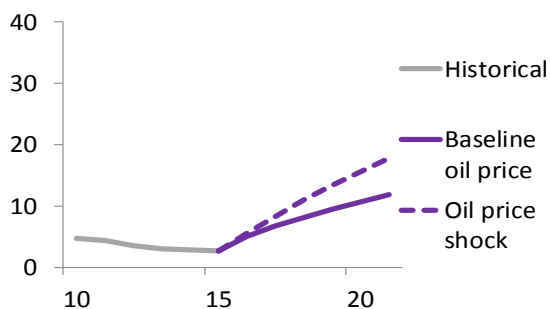
Loan to deposit ratio



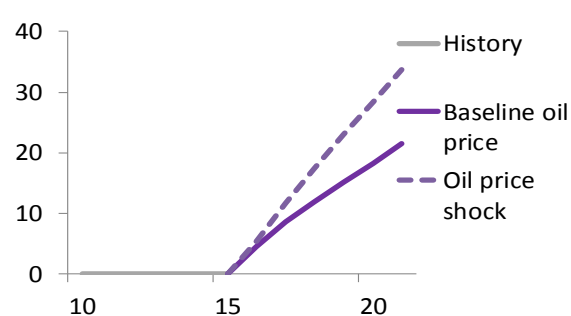
Private sector credit growth (% yoy)



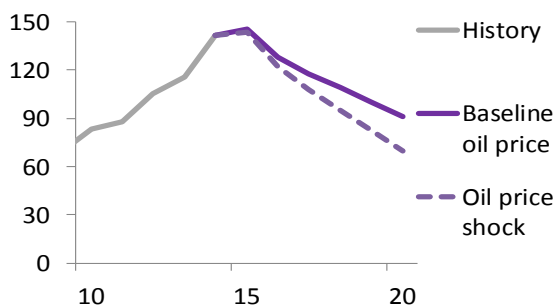
Bank holdings of gov. bonds (% of assets)



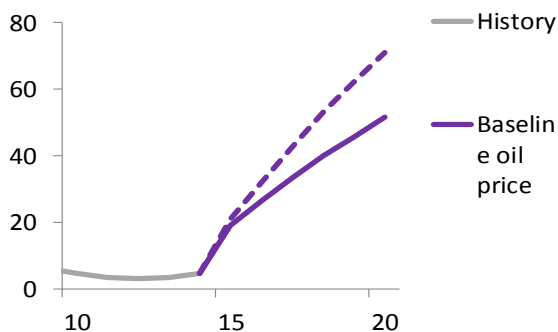
Non-banks holdings of dom. assets (% of assets)



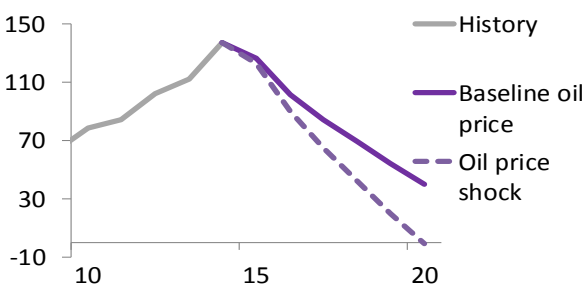
Buffer (% of GDP)



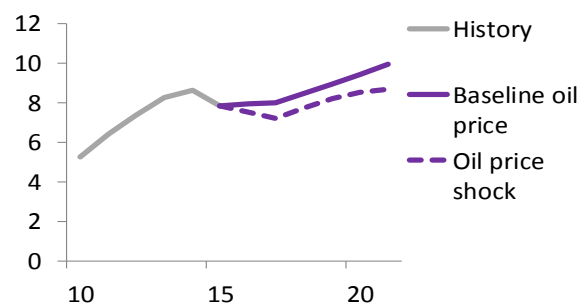
Debt (% of GDP)



Net buffer (% GDP)



Central Bank Reserves (KD billion)



Source: IMF staff calculations.

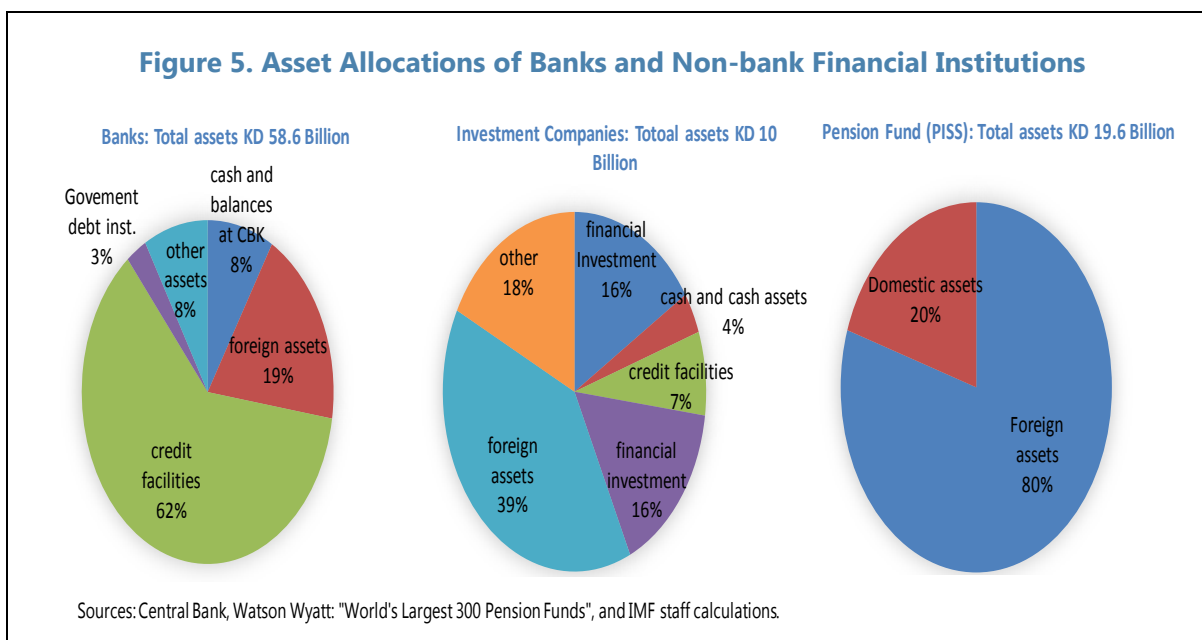
Summary Findings

- *Large reliance on buffers would be associated with better outcomes for domestic liquidity and credit to the private sector and for central bank reserves. This worsens the net government buffer position, although it remains large.*
- *Large reliance on domestic financing would entail significant reallocation of banks and nonbanks assets and could lead to a crowding-out effect on private sector credit and slower growth of central bank reserves. It would also help preserve a larger buffer, but at the expense of higher debt.*
- *The balanced financing mix scenario (buffer, external borrowing, and domestic borrowing from banks and nonbanks) yields better outcomes in terms of maintaining large buffers and tapping domestic and external markets without much crowding out effect and pressures on the CBK reserves, compared to the other scenarios.*
- *Under a negative oil price shock, and unchanged fiscal policy, the financing needs would increase and, even under a balanced financing mix, have negative outcomes, underscoring the need to combine the balanced financing mix with fiscal adjustment.*

E. Broadening the Investor Base

32. Broadening the investor base is important for ensuring stable, strong and sustainable demand for government debt securities. A diversified investor base is a key element to facilitating deeper primary and secondary markets. It is critical for enabling the government to execute its funding strategy under a wide range of market conditions, thereby minimizing long-term execution and refinancing risk, increasing funding efficiency, and hence alleviating the negative economic and financial effects of higher government debt, including the crowding out of banking credit to the private sector. In a mature market, the investor base should ideally include both domestic and foreign investors and all types of institutions—ranging from commercial and retail banks to corporate treasuries, insurance companies, mutual funds, pension funds as well as individual investors.

33. Kuwait has potentially a large and diversified investor base for government debt. It includes, in addition to banks, investment companies, a sizable mutual funds market, the pension fund, and potentially high-net-worth individuals and public enterprises such as the Kuwait Petroleum Company. Kuwait also has large potential to access global markets, using both conventional and sukuk instruments. Debt issuance has so far targeted only domestic banks as a first and straight forward step— given that procedures and accounting and IT systems are already in place at the CBK to perform transactions with banks. For other markets, there will be a longer lead time to address legal and capacity constraints, including developing the procedures at the CBK to perform open-market transactions with nonbank institutions.



34. The banking system dominates the financial sector and is expected to absorb a large share of government debt instruments. Banks represent more than 80 percent of the financial sector. They are well capitalized, profitable, liquid, and show resilience to various stress scenarios (see next accompanying paper). Banks hold about 8 percent of their assets in cash and cash assets which will determine market capacity, at least in the short run, to absorb further government debt instruments—currently represent only 3 percent of total assets (Figure 5). This will be sufficient to absorb what is currently being envisaged for this years' issuance without much, if any, crowding out other assets. Beyond this, a larger portfolio of public debt instruments will need to be accommodated by reducing other assets on banks' balance sheet including credit facilities and foreign assets, which accounted for 62 percent and 22 percent of total banks assets, respectively, as of end June 2016.

35. Kuwait should expedite work on sukuk legislation to benefit from the large Islamic financing sector. The Islamic finance industry includes banks, investment companies (ICs), investment funds, and insurance (Takaful) and reinsurance (Retakaful) companies. As of June 2015, Kuwait had the fifth largest share of Islamic banking assets and the sixth largest share of Islamic funds. In the banking sector, five of the 11 locally registered commercial banks and one out of the 12 branches of foreign banks were conducting business in accordance with Sharia. Kuwait has not launched a public benchmark sukuk financing but is working on the regulations. The sukuk market has remained small and has been dominated by corporates issuing outside Kuwait. New Basel III regulations strongly support issuance of government sukuks and according to Law No.3 of 2009, sukuk instruments can be offered by the CBK as a means of borrowing.

36. Investment companies (ICs) should be considered as a potential financing source. Despite significant deleveraging since end 2008 (assets shrank by 36 percent, and assets under management shrank by 15 percent), ICs maintain a large proportion of the financial sector assets, second to banks, with own assets representing 15 percent of GDP by end of 2015 (total assets

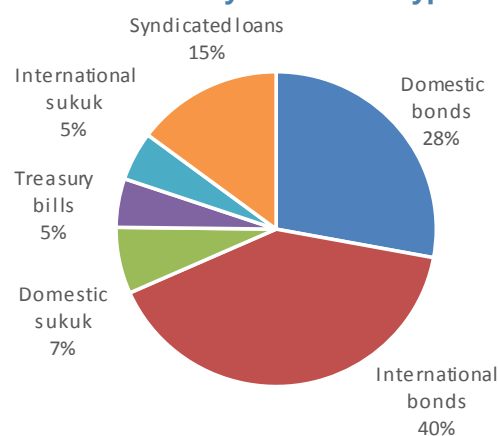
including managed assets account for more than 56 percent of GDP).¹¹ ICs could benefit from new investment opportunities in government debt instruments by allowing them to diversify domestic investment portfolios and help reduce their exposures and risks and improve their financial positions. This would in turn help reduce risks to banks which are interconnected to ICs through lending and cross ownerships.

37. The government could expand the investor base to long-term institutional investors, such as insurance companies and the pension fund which have not been large buyers of government securities. Kuwait's only pension fund, the Public Institute for Social Security (PIFSS) is well-capitalized relative to the size of the economy and citizen population—its assets relative to population are similar to those of the UK's pension funds (EY 2015). The PIFSS assets stood at close to KD 20 billion in 2015, mostly held in investments abroad (80 percent). The insurance sector, on the other hand is small (about \$3.2 billion or 2 percent of GDP by end of 2014) but could nonetheless absorb part of the debt issuance and benefit from the existence of market for long term maturity instrument (Moody's 2015). As the government works to develop a more complete yield curve, it will need to understand the asset and liability structures of varying institutional investors (e.g., insurance companies or the pension fund) when selecting exact maturity, timing and volume expectations for longer-dated issues.

38. Any borrowing from the pension fund should take into consideration the fund's investment strategy and risk of creating future contingent liabilities. Currently the PIFSS does not invest in government debt instruments and the authorities are considering issuance of bonds in lieu of cash payments for social security contributions. Indications are that the rate of return on the PIFSS investment portfolio is significantly higher than the rate at which the government has been borrowing from banks. Borrowing at a higher rate would be costly for the government while imposing a lower rate on the PIFSS would reduce its investment income and, if large, could negatively affect its actuarial position. Given the PIFSS investments are public assets and the government would ultimately bear any future unfunded liabilities, this issue should be addressed in the context of a sovereign overall assets/liabilities management framework.

39. Appetite for Kuwait's sovereign issuance of conventional bonds and Islamic sukuk should help expand the investor base externally. The authorities should expedite the preparatory work for international placement of bonds and sukuk to take advantage of the favorable global financing environment. Other oil exporters have been able to diversify

Figure 6. GCC, CCA and Algeria: Outstanding Marketable Debt by Instrument Type



Sources: Bloomberg, L.P.; country authorities; and IMF staff calculations.
Note: Data for Algeria is as of end-December 2015.

¹¹ There are 85 investment companies—38 conventional and 47 operating in accordance with the provisions of Islamic law.

borrowing externally fairly quickly. As of August 31, 2016, 60 percent of outstanding marketable debt of Algeria, GCC, and CCA oil exporters comprised international securities. This is also reflected in the currency composition, with only 40 percent denominated in local currency, indicating some exposure to exchange rate risk. However, interest rate and rollover risks appear limited given the dominance of debt with fixed coupons (73 percent of total marketable debt) and only 13 percent due to be repaid within 12 months (IMF 2016).

40. Consideration should be given to the potential role of high net-worth individuals and foreign investors in the domestic securities market. Moreover, reform efforts to increase financial inclusion could help broaden the investor base. These efforts could bring more savings into the formal financial sector, thereby increasing the size of bank balance sheets, and encourage the further development of the insurance and mutual fund industries to help mobilize national saving.

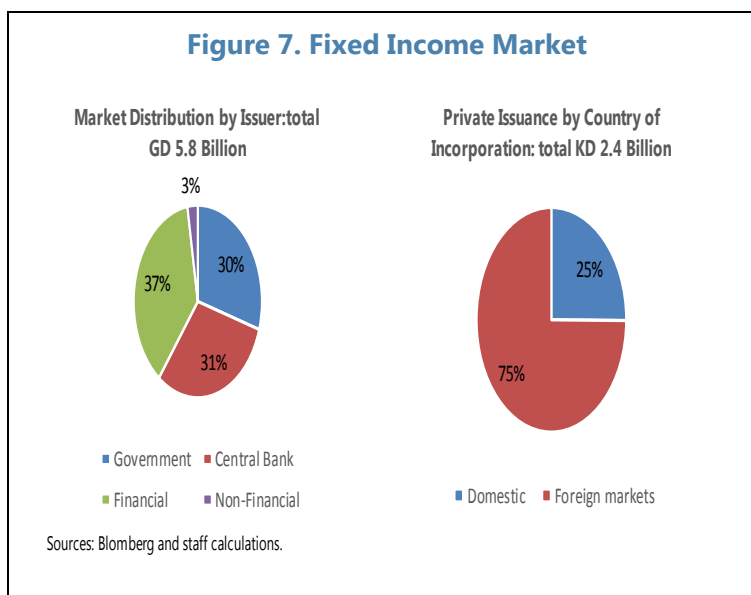
F. Developing the Domestic Debt market and Strengthening Debt Management Capacity

41. Borrowing with the purpose of creating a government debt market has its own merits — irrespective of the financing needs. Even if financing needs disappear, the government may need to continue to issue domestic debt regularly to supply the market with liquid debt instruments. A deep domestic debt market would contribute to financial deepening and stability. Local-currency public debt instruments are generally considered to be the “risk-free” investment alternative in the domestic economy, fulfilling an important role as a store of value and as a reference price for other financial assets including corporate bonds (IMF 2014). A government bond curve is therefore a key cornerstone for enabling other issuers to access the markets, facilitating the development of a credit curve and diversifying funding sources for companies away from traditional banking sector resources.¹² In this regard, it would be important to undertake government borrowing through issuance of debt securities rather than by loans, not only to develop the secondary markets for government debt but also to support liquidity management by allowing banks to use bonds as collateral for central bank facilities or interbank markets if necessary (IMF 2016).

¹² The lack of pricing benchmarks via a sovereign curve is frequently highlighted as a cause for the underdeveloped nature of Kuwait’s credit markets.

42. Currently, the fixed-income market is small and there is room to improve public debt management capacity.

The outstanding public debt instruments and CBK bonds at end July 2015 represented less than 5 percent and 6 percent of GDP, respectively. The size of the corporate bond market is also small, about 1.6 percent of GDP in the domestic market and 5 percent of GDP in foreign currency-denominated bonds (mostly issued outside Kuwait), Figure 7. The domestic part represents about 2.3 percent of bank financing (outstanding loans to the different business sectors stood at about KD 20 million by June 2016).



There is virtually no secondary market for these bonds. On capacity to manage public debt, both the CBK and KIA have been performing some operational functions applicable to debt and asset management. However, there is no fully-fledged unit with a mandate to perform all the core functions related to debt management. The recent establishment of the Debt Management Committee as recommended by the IMF is a welcome step forward and the debt management unit under development would need to support this committee.

43. Effective debt management requires a sound institutional structure. Consolidating debt management into one operating unit (Debt Management Unit— DMU) at the MOF is an important step towards avoiding duplication of functions, strengthening accountability, and reducing coordination requirements. Assigning core debt functions to the MoF would help separate debt management from monetary policy to ensure that conflict between these two important public policy objectives is minimized. This should involve assigning to the DMU the middle-office functions, which include strategy development as well as risk management and reporting. While retaining overall responsibility for debt management policy within the DMU, it is possible to continue to contract out the front and back office functions to the CBK and KIA. In this case, agency agreements should be employed to set out clear roles and responsibilities, and performance measurement criteria. Operationalizing the recently established DMU should be a priority, including by advancing staffing according to clear job descriptions, producing the DMU by-laws, and providing the unit access to public debt records managed by the other agencies.

44. A formal debt management strategy is needed to guide the overall debt management.

Developing and annually updating the strategy should be one of the core functions of the DMU and should involve: (i) clear objectives of debt management in line with macroeconomic environment and fiscal and monetary policies. It should also include objectives other than financing such as the development of the domestic debt market; (ii) assessment of the costs and risks of alternatives to borrowing based on a comprehensive assets/liabilities management approach; and (iii) the scope of

the public debt, providing clarity about what constitutes the “public debt”—types of public institutions and instruments, and specify the portfolio composition.

45. Improving debt issuance practices would help. Developing a market-based auction framework by transitioning over time to an electronic platform, introducing competitive pricing and allocations, making auction parameters predictable and transparent (held at regular intervals and visible to a broad audience through publishing an annual borrowing program and auction calendar, outlining expected borrowing needs and future funding plans) would help develop domestic debt markets and reduce borrowing costs. So would using primary dealers when the conditions allow. The maturity structure of the bonds issued should be geared towards developing the debt market. While there will likely be more appetite for shorter maturities at the beginning of the process, over time, as investors become more comfortable with government securities and gain experience with the first new benchmark issues, longer-dated tranches can be investigated and launched. The maturity structure should eventually create market depth on a few benchmark maturities (5- and 10-year instruments and longer if the Law is amended to allow for longer maturities).

46. Addressing the legal constraints would allow the build up of sizable debt across maturities. The current law on government borrowing should be amended as recommended by the debt committee including to increase the current debt ceiling of KD 10 billion which implies that less than 40 percent of the funding needs can be borrowed, and extend duration on financing operations beyond current limit of 2017. At the same time, it could consider lifting the limit on the borrowing tenor and allow borrowing for longer than 10 years. Moreover, it is important to establish the legal framework for domestic and international sovereign sukuk— the sukuk law and the constitutional constraint on using public properties as collateral to allow the issuance of assets-backed sukuk.

G. Conclusions and Policy Recommendations

47. Kuwait can flexibly choose from a menu of options to finance the emerging deficits. With large buffers, low debt and a good credit rating, the government can use some of its GRF buffer and tap international and domestic markets, both in conventional and Islamic debt instruments. Reliance on the buffer in the coming months can give breathing space for the government to do the preparatory work needed for larger domestic issuance and placing bonds in the international markets. However, financing should not be substitute for fiscal adjustment which is needed to reduce budget’s vulnerabilities and rigidities and reduce the financing needs to more manageable levels under further oil price shocks.

48. The financing issue should be addressed in the context of a comprehensive asset/liability management framework, with a view to minimizing cost and risks for the overall economy. This involves not only basing decisions on cost of borrowing versus return on assets, but also the financial characteristics of sovereign assets and liabilities to ensure there are no mismatches that could expose the country as a whole to a wide range of risks, including interest rate and exchange rate risks, and sufficient liquid buffers are maintained as insurance against shocks.

Other macro-financial factors and objectives of the financing policy should be taken into considerations in a formal debt management strategy.

49. Increased formal coordination and transparency would help ensure effective asset and liability management. This includes institutional and policy coordination, for instance debt management and monetary policies, assets accumulation/drawdown and central banks reserves, as well as operational coordination— cash management, information sharing, currency and maturity structure of debt and assets portfolio. Disclosure of the KIA assets and their division between those under the FGF and the GRF and recording transparently fiscal accounts and linkages with the KIA in line with best practices would be particularly useful to boost investor confidence as Kuwait seeks to access global markets and build up debt.

50. There may be merits in borrowing now while the government maintains a substantial portfolio of assets. From a cost/risk perspective, the financing environment is favorable now for external borrowing and local markets can easily absorb a significant portion of government debt. This way, maintaining buffers can be seen as an insurance for future tightening of the financing environment. Borrowing could have the added value of increasing fiscal discipline and help the government establish a deeper market for government debt.

51. The implications of the various borrowing options can be minimized and addressed by appropriate policy response. The first step is at the design of the debt management plan by ensuring the financing mix and debt maturity structures are appropriate. The implications of domestic borrowing on banking liquidity and credit to the private sector could be mitigated through monetary and macro prudential instruments, broadening the investor base to non-banks, and development of the corporate bond market. To protect the CBK reserves, the government could consider institutionalizing an arrangement based on a clear policy and procedures for transferring foreign exchange to support the CBK reserves.

52. Domestic financing should be seen as an opportunity to develop the fixed income market. To this end, an effective debt management strategy, operationalizing the DMU, developing cash management capacity, and developing the auction system would be important. Other key steps include broadening the investor base (to include Islamic banks, investment companies, the pension fund and insurance companies), putting in place sound institutional and regulator frameworks, addressing legal constraints to government borrowing and sukuk issuance, and developing the secondary markets.

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MACRO-FINANCIAL LINKAGES AND RESILIENCE OF THE FINANCIAL SECTOR¹

A. Introduction

1. Kuwait's financial system has remained sound despite the headwinds from the slump in oil prices that are exerting pressures on the macro economy. With hydrocarbons accounting for about half of GDP and well over two thirds of fiscal and export revenues, the decline in oil prices has led to a sharp deterioration in fiscal and external accounts and a softening in nonoil GDP growth. However, while equity markets also corrected and the real estate market has begun to slow down, the banking system has continued to perform well.

2. This paper identifies macro-financial linkages, assesses the resilience of the financial system, and discusses policy options to safeguard financial stability. The paper focuses on the banking sector but also discusses the financial markets, equities and investment companies in so far as their performance impact banking system stability. It also provides a comparative analysis of conventional and Islamic banks' performance and employs a balance sheet approach to identify risks from households and corporates. Stress tests to determine banks resilience to shocks is undertaken at both the aggregate and bank by bank level, and builds on earlier work by Fayad (2015).

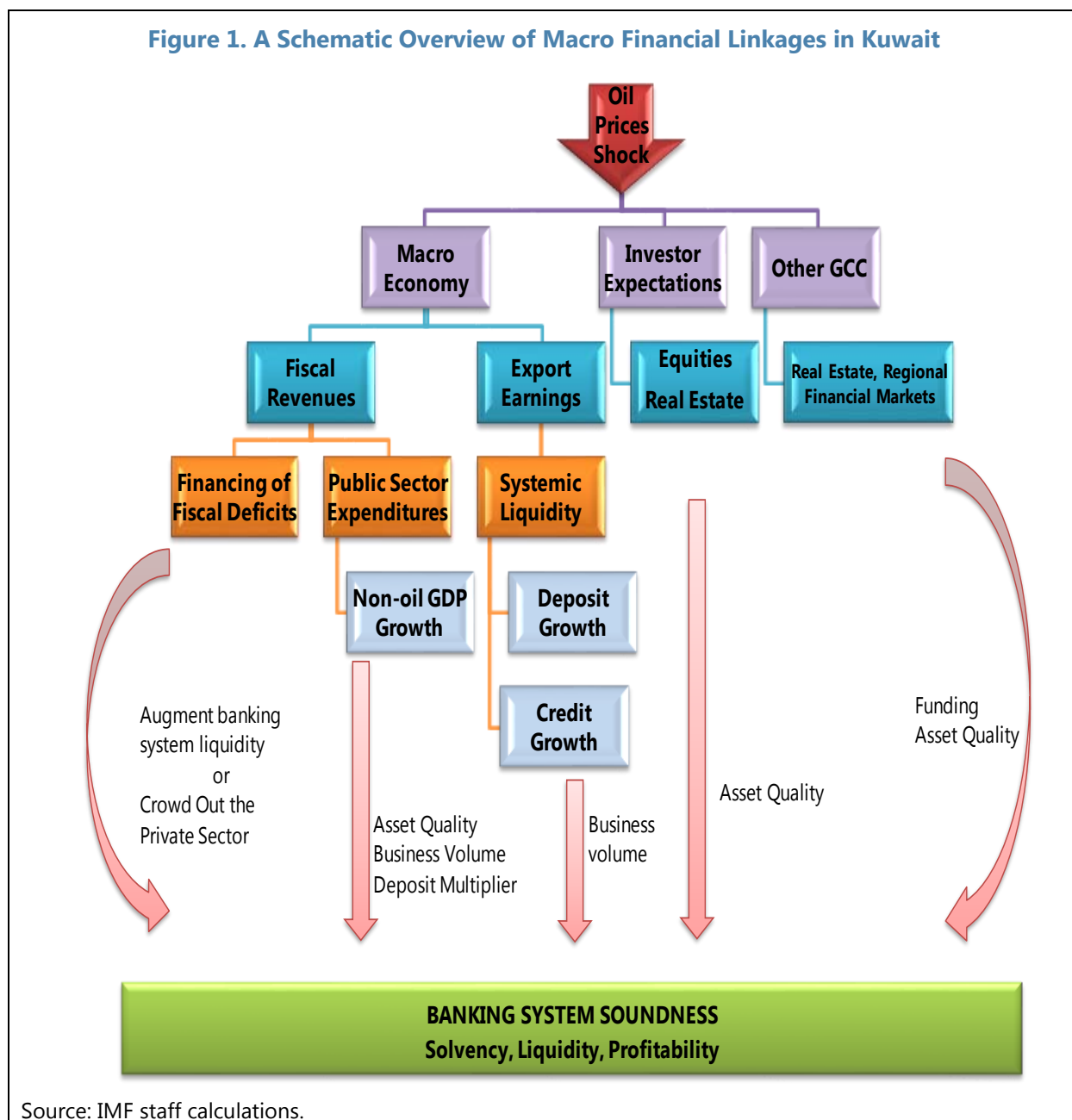
3. The paper is structured as follows. Section II discusses Kuwait's macro financial structure, and highlights the channels through which oil price shocks propagate through the macro economy to the financial sector, as well as the feedback from the financial sector to the macro-economy. Section III reviews Kuwait's financial sector performance since oil prices began to decline in June 2014, and the drivers of that performance, including policy responses to the shocks. Section IV uses stress testing techniques to assess the resilience of the banking system to macro financial risks and highlights the comparative resilience of Islamic and conventional banks. Section V assesses the adequacy of liquidity management and prudential frameworks to mitigate financial stability risks and the arrangements for crisis management, in case banking system stresses emerge. Section VI summarizes the findings and highlights policy options to safeguard financial stability.

B. Overview of Macro-Financial Linkages in Kuwait

4. Kuwait's financial sector performance is interwoven with the oil price cycle through multiple channels that form a complex web of interactions. Changes in oil prices affect the financial sector through its impact on the domestic macro-economy, expectations and, to some degree, through spillovers from regional financial markets (Figure 1). These channels also interact with each other in a complex way, thus the impact on the banking system is non-linear. The speed with which the shocks transmit to the financial system vary between financial markets and institutions and also depend on the authorities' policy response.

¹ Prepared by Inutu Lukonga.

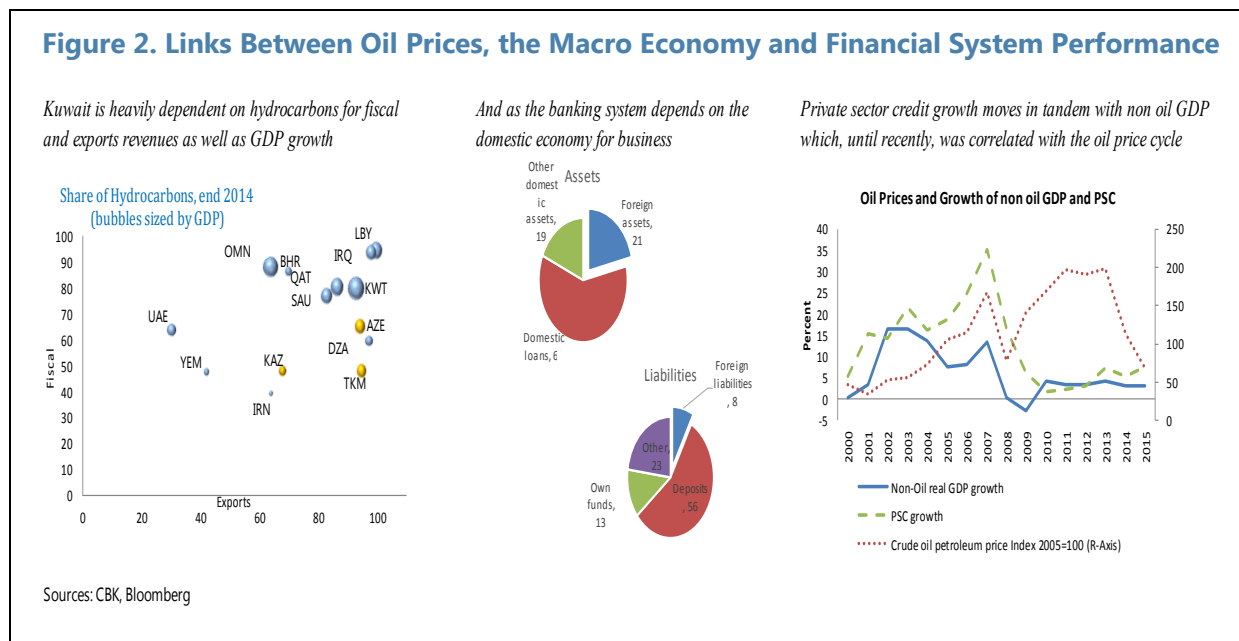
Figure 1. A Schematic Overview of Macro Financial Linkages in Kuwait



The Domestic Macro Economy Channel

5. Oil price shocks can impact several macro variables simultaneously and create multiple and mutual reinforcing risk channels for the banking sector. Before the oil price shock, hydrocarbons accounted for over 90 percent of exports and fiscal revenues and close to 60 percent of GDP. As a consequence, declining oil prices typically impact the balance of payments and system wide liquidity, which slows down deposit growth. The deceleration in deposit growth, in turn, can curtail credit growth, business volume, profitability and, therefore, internal capital generation. Concurrently, reduced fiscal revenues—should it lead to curtailed public expenditures—could slowdown non-oil GDP growth, household disposable income, demand for and supply of credit and

reduce debt service capacity of both households and corporates.² In the past couple of years, however, these inter-relations have weakened, as large accumulated fiscal buffers have provided the policy space to maintain public expenditures in a low oil price environment, thereby limiting the potential adverse impact of low oil prices on the real economy and liquidity (Figure 2).



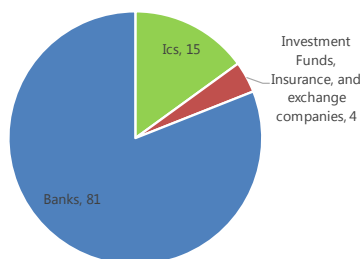
6. Transmission of the macro shocks to the banking sector and broader financial system occurs with a short lag because banks derive most of the business from the domestic economy and financial segments are interlinked. Kuwait’s financial system is bank dominated, with commercial banks accounting for about 80 percent of total financial system assets. Banks largely depend on domestic market for business, with domestic liabilities accounting for 92 percent of total liabilities while domestic assets account for 80 percent of banking system assets. Banks also account for over half of stock market capitalization and are a significant source of funding for investment companies (ICs), equities and real estate markets (Figure 3).

² The private sector derives a large share of their business from government contracts and the government also accounts for more than 45 percent of employment in Kuwait.

Figure 3. Banking System Linkages with the Financial System

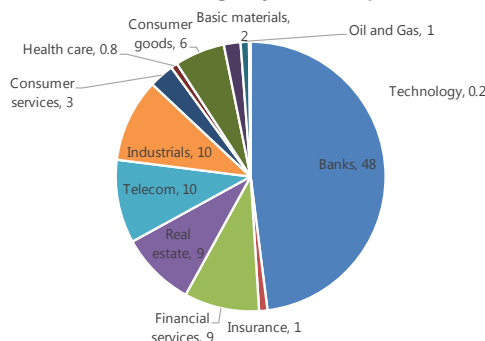
Kuwait's financial system is bank dominated...

Financial system structure, 2014



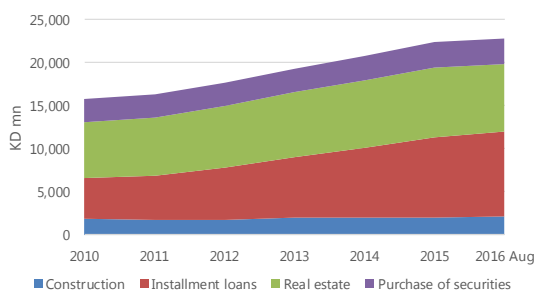
...and the performance of banks and equities are interlinked given the large share of banks in stock market capitalisation

Sector Weight by Market Cap



Banks are also a significant source of funding for real estate and equities...

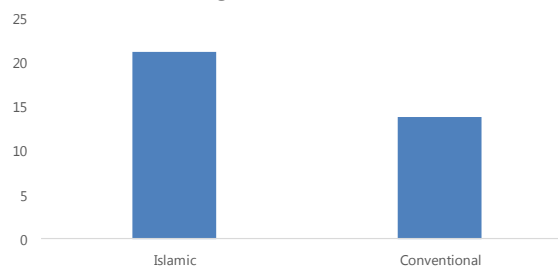
Bank Loans to Construction, Real Estate and Equities



Source: CBK.

...and also for Investment Companies

Investment Companies Funding from Local Banks, July 2016 (Percentage Share of Total Liabilities)

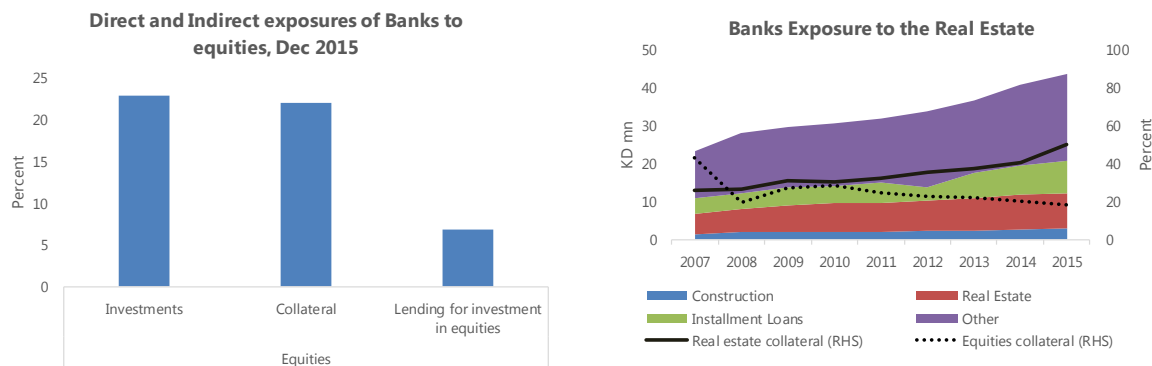


The Expectations Channel

7. Oil price shocks affect expectations about the business environment which, in turn, affects investments in asset markets and the broader economy. Given the heavy economic dependence on hydrocarbons, declines in oil prices, by weakening confidence and possibly giving rise to expectations of a slowdown in the real economy, can create negative expectations of a slowdown in the real economy, which affect investment decisions and discourage investments in equities and real estate. Pressures on asset prices can also adversely affect the financials of banks and ICs, as both have direct and indirect exposures to equities and real estate through loans, investments and collateral (Figure 4). This could also create negative feedback loops within the financial sector given the interlinkages alluded above.

Figure 4. Financial Linkages of Banks with Equities, Real Estate and Investment Companies

Banks are exposed to fluctuations in equities through various exposures, including investments, collateral and lending *The exposure of banks to the real estate are mostly through lending and collaterals*



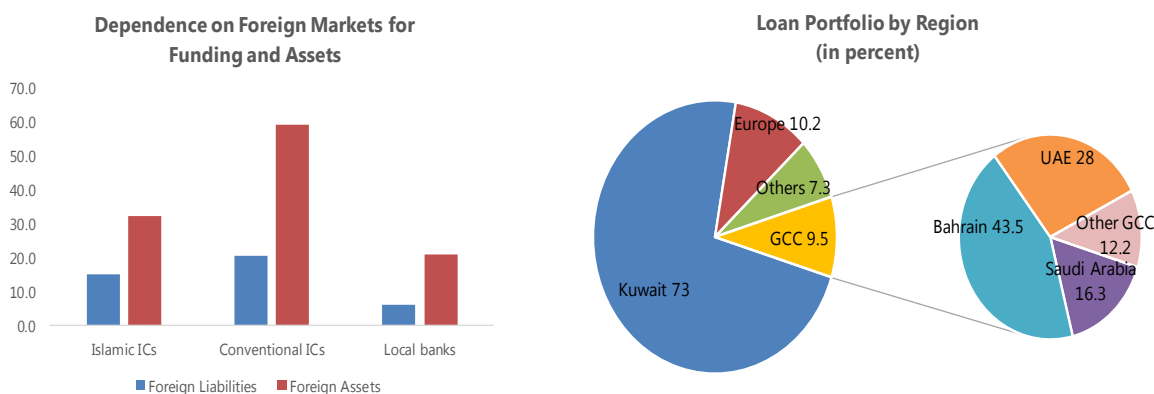
Source: CBK.

Regional Spillovers

8. Developments in the regional markets have some implications for financial stability in Kuwait through financial and ownership linkages. At end July 2016, local banks’ foreign liabilities and foreign assets accounted for 5 percent and 20 percent of banking system assets, respectively. The GCC accounts for about 10 percent of the total loans (Figure 5). A number of Kuwait banks also have subsidiaries operating in the region and other countries, including some with challenging operating environments such as Iraq, Egypt, Tunisia, Turkey and Algeria. The banks are, therefore, directly exposed to regional equities and real estate through their subsidiaries’ lending activities and investments in the host markets. The share of ICs foreign liabilities accounted for 15 and 20 percent for Islamic and conventional companies, while foreign assets averaged 32 and 59 percent, respectively. Shock transmission from the ICs to banks has, however, significantly weakened since the Global Financial Crisis (GFC), because of the reduced balance sheets of ICs following the various restructurings and the reduced financial exposures by banks.

Figure 5. Spillover Channels from Regional Financial Markets

Foreign financial markets are an important source of funding and asset expansion, particularly for Investment companies While the domestic market accounts for the bulk of loans, the GCC is an important market for some Kuwait banks



Source: CBK.

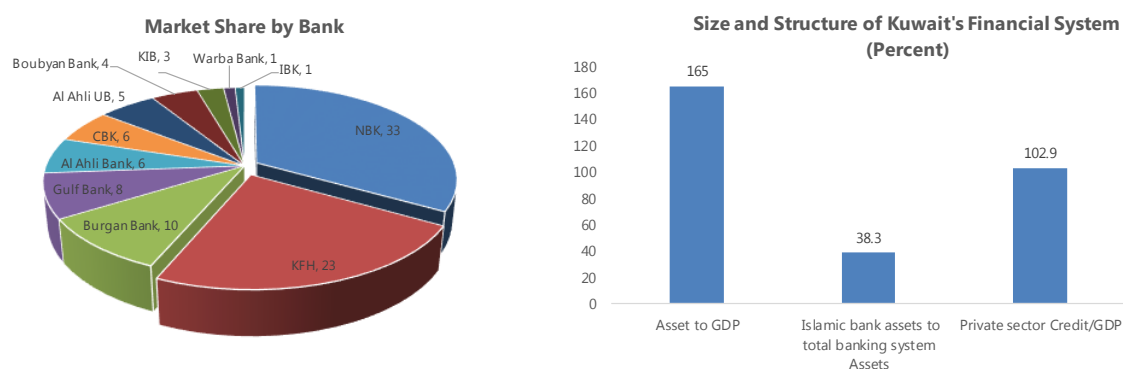
Feedback from the Financial System to the Macro Economy

9. Kuwait's financial system structure and performance has the potential to affect macroeconomic performance through a number of channels, most notably the credit and fiscal channels. The banking system is the principal source of credit for corporates and households, thus a slowdown in credit can affect growth through both investment and consumption. The banking system is also concentrated and this creates systemically important banks that could have fiscal implications in a stress scenario. Due to the high retail participation in Kuwait's stock market, declines in the stock market have a wealth effect that can affect consumption and nonoil GDP growth. The significant presence of Islamic banks in the financial system has potential implications for monetary policy conduct and transmission through the interest rate channels. However, because the CBK has developed Shari'ah compliant monetary instruments and the Islamic banks assets comprise largely of financing items (Murabahah and Ijara) whose characteristics are similar to conventional banks, transmission of monetary policy to the real economy has not been materially impacted (Figure 6).

Figure 6. Feedback Effects

The high concentration in Kuwait's banking system creates systemically important banks

Intermediation levels are high and the dual banking system can have implications for monetary policy



Source: CBK.

C. Financial Sector Performance since the Oil Price Shock and Drivers

10. Kuwait's financial sector has remained sound and stable, with incipient pressures largely mitigated by broadly supporting fiscal and monetary policy responses. The slump in oil prices exerted further pressures in equity markets and more recently dampened real estate transactions while money markets and financial institutions have continued their strong performance. Generally supportive fiscal policies, a neutral monetary policy stance, the dividends of sustained financial sector reforms and strong economic performance have provided a favorable operating environment for banks.

Financial Sector Performance

11. Pressures from the slump in oil prices, that began in June 2014, have been largely felt in asset markets. Equity markets that were slowly recovering from the effects of the GFC registered broad based declines and increased volatility, in tandem with other equity markets in the region.³ The real estate market cooled significantly in 2015, following a strong five year run, with sales in both investment and residential real estate sectors declining by 45 and 31 percent by the second quarter of 2016. Liquidity in interbank markets, which had begun to decline towards the end of 2015 eased thereafter and, as a result, inter-bank rates declined even as policy rates were raised in December 2015 following the increase in US rates.⁴

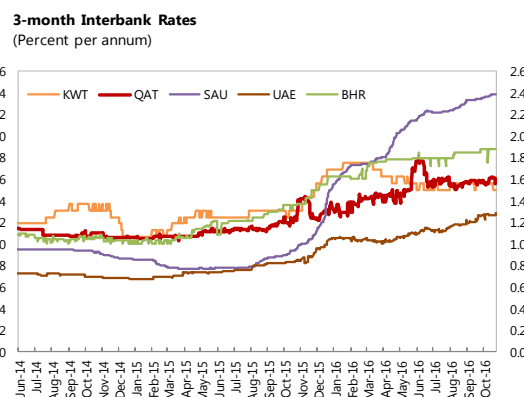
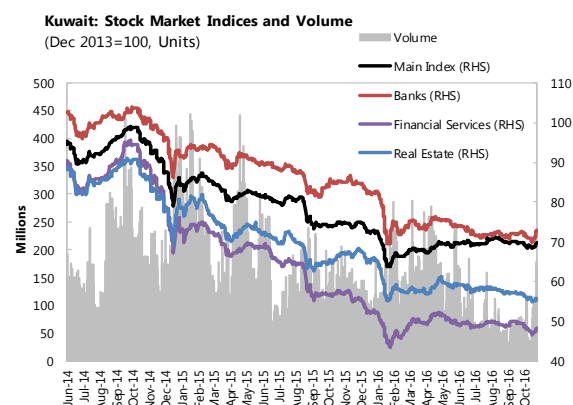
³ The Kuwait Stock exchange index which had declined by 13 percent between December 2008 and June 2014 declined further by another 22 percent through September 2016.

⁴ Kuwait is pegged to a basket of currencies and has maintained the peg. Policy rates in Kuwait have been largely correlated with US rates.

Figure 7. Financial Market Performance

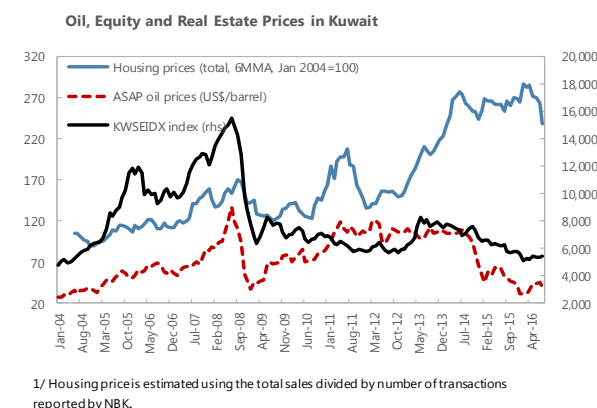
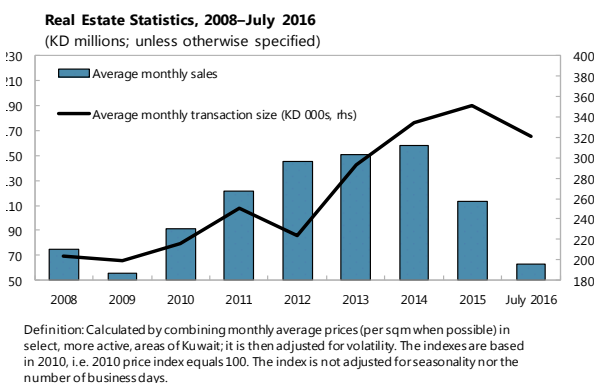
Stock markets tumbled following the decline in oil prices in June 2014

Interbank rates remain comparatively elevated, but they have come down despite the increase in policy rates



But while the real estate market cooled off after a five year run

There has been some decoupling in the trends between the real estate sector, on one hand, and oil prices and equities



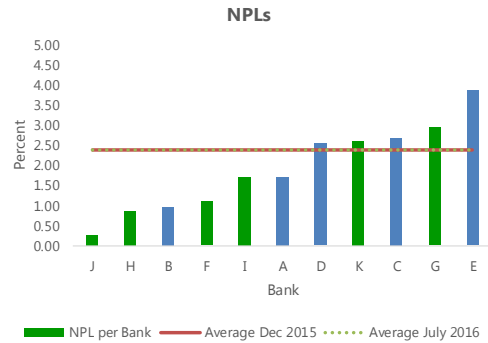
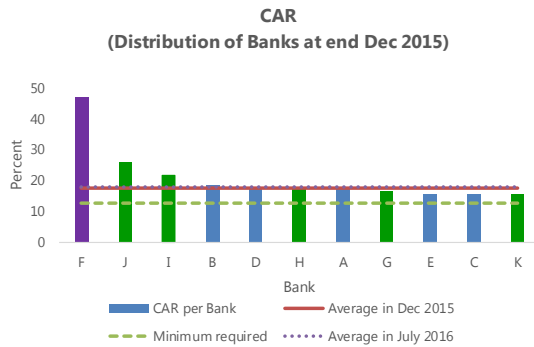
Sources: Bloomberg, and NBK.

12. Banking sector fundamentals have remained sound (Figure 8). The aggregate capital adequacy ratios (CAR), which has been trending up since 2014 from an already elevated level of 16.9 percent, was estimated at 17.9 percent by July 2016, in part reflecting the capital raising efforts to meet Basel III capital requirements. NPLs have steadily declined to 2.4 percent, reflecting a combination of loan write offs and the steady growth in new loans. Loan loss provisioning has been increasing and coverage averaged 206.2 percent. The banking system remains profitable, though margins have been declining. In addition, several indicators of liquidity point to a banking system that enjoys ample liquidity, despite the reduced oil related inflows, reflecting, to some degree, increased public sector deposits. Both conventional and Islamic banks performed well, although there are some disparities in performance across individual banks (Figure 8).

Figure 8. Banking Sector Performance

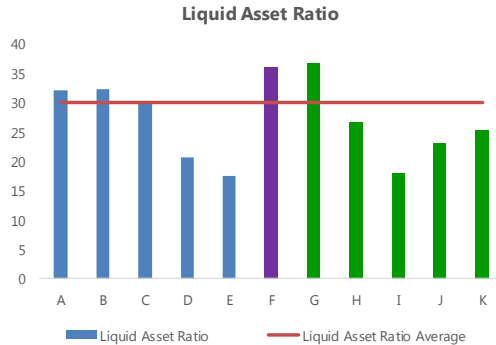
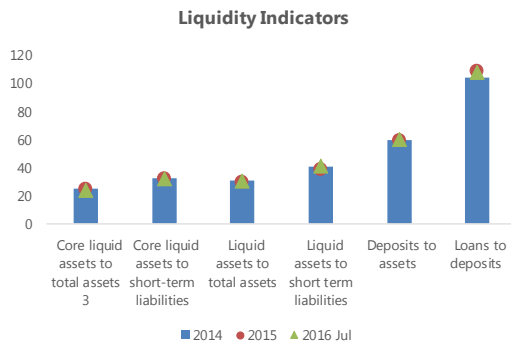
Capital adequacy ratios are high with all banks above the statutory limit

NPLs, though low, show a skewed distribution with a number of banks above the industry average



Several indicators of liquidity point to a banking system that enjoys ample liquidity

But there are also some notable differences in the liquidity condition of banks



Source: CBK

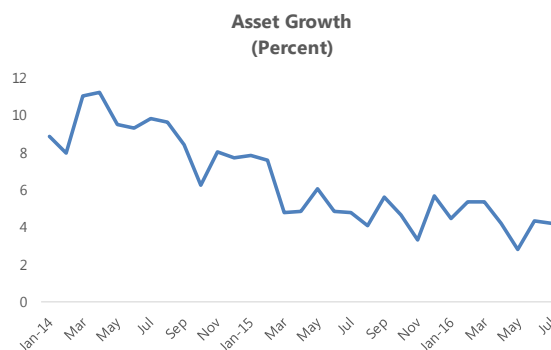
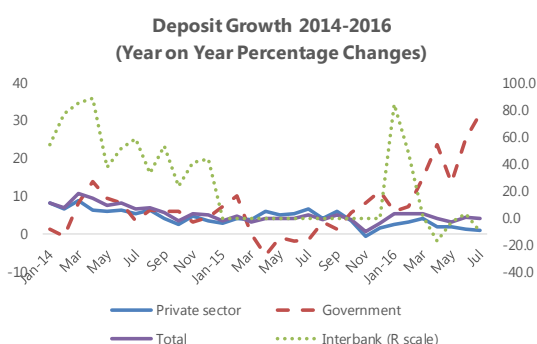
Note: the blue bars are conventional banks, the green bars are Islamic banks, and purple bar is a specialized bank.

13. The banking system is, nevertheless, exhibiting some incipient pressures. Banking system asset and deposit growth, though still positive, have slowed down significantly. Deposit growth moderated from 7 percent in 2014 to 3.8 percent in 2015 and only modestly picked up to 4.6 percent in the first half of 2016, helped by increases in government deposits. Bank asset growth exhibited a similar trend, declining from 9 percent in 2014 to 5.3 in 2015 and 4.4 in the first half of 2016. Credit growth, by contrast, accelerated to about 8 percent in 2015 (compared with 6.3 percent in 2014) with all sectors registering higher growth except the real estate sector. As of end-September 2016, total credit was still growing at around 7 percent year-over-year, but with a decline in credit to the real estate sector and consumer loans.⁵

⁵ The decline in lending to the real estate and households is largely attributed to the enforcement of the regulation that requires borrowers to provide proof of deployment of credit for the purpose for which it was approved for and weakening consumer confidence.

Figure 9. Deposit and Credit Growth

Deposit growth has slowed though increases in government And asset growth has steadily declined, with some banks and wholesale funds moderated the pace registering a contraction in their assets



But credit growth remains robust and accelerated in 2015 across all sectors except the real estate

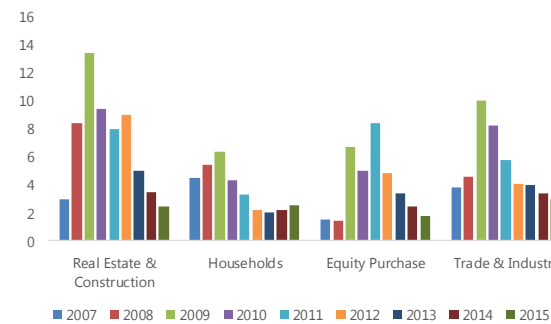
NPLs have declined across sectors, but 2015 witnessed an uptick in NPLs from households

Distribution of Credit Facilities by sector and rate of growth

	2015 Balance (KD mn)	Percent of Total Facilities	Rate of Growth	
			2015	2014
Trade	3114.8	9.4	9.4	3.7
Industry	2035.8	6.1	16.8	-1.7
Construction	1953.3	5.9	2.5	-0.5
Personal services	13835.3	41.7	11.1	10.4
Real estate	8048.8	24.2	2	3.8
Other	4221.6	12.7	8.3	8.4
Total	33210	100.0	8.1	6.3

Source: CBK.

Non performing loans by Sector



Key Drivers

14. The overall strong performance of the banking sector reflects a combination of policy and other factors. These include supportive macro policies, dividends of enhanced risk management, and structural and other coincidental factors.

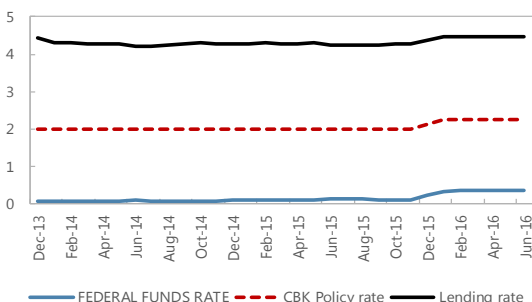
15. Fiscal and monetary policies have been supportive. A very gradual adjustment of current expenditures combined with a continued increase in growth enhancing capital expenditures has supported nonoil GDP growth and provided business opportunities that supported both asset growth and quality. The resulting deficit has, thus far, been financed mainly by drawing down external buffers, and public sector entities have at the same time increased their deposits in the banking sector. While the government stepped up government bond issuance since April 2016, the magnitudes issued were limited to avoid crowding out the private sector. As a result, the impact on system wide liquidity has been limited. The initial increase in interest rates in tandem with the

interest rate hike by United States Federal Reserve in December 2015,⁶ and improving confidence on account of the recovery in oil prices helped moderate the capital outflows, which would otherwise have tightened liquidity conditions. Monetary operations were neutral with the CBK rolling over its maturing bonds.

Figure 10. Drivers of Banking System Performance

In tandem with US Fed rate, the CBK increased its policy rate, as a result of which lending rates were also increased

Interest Rates (in percent)



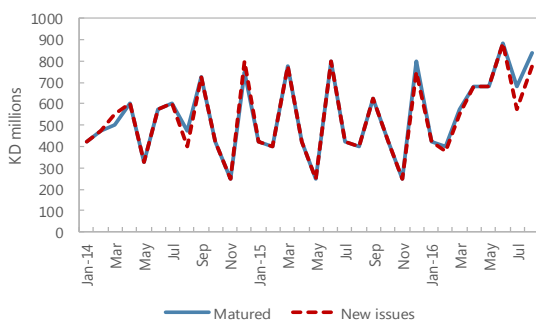
The decline in capital flows was arrested which also helped ease potential liquidity pressures

Kuwait EPFR Cumulative Funds Flows (December 2013=0, in US\$ billions)



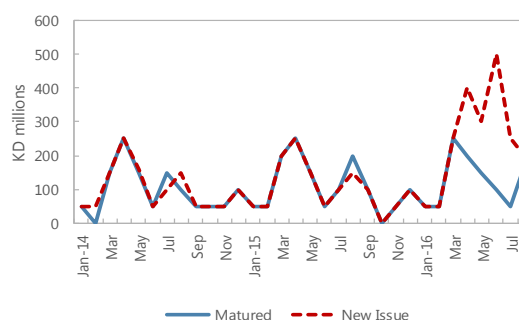
Monetary operations were neutral, as the CBK mostly rolled over maturing bonds

CBK Bond Maturities and New Issues



Bond issuance were increased

Treasury Bonds



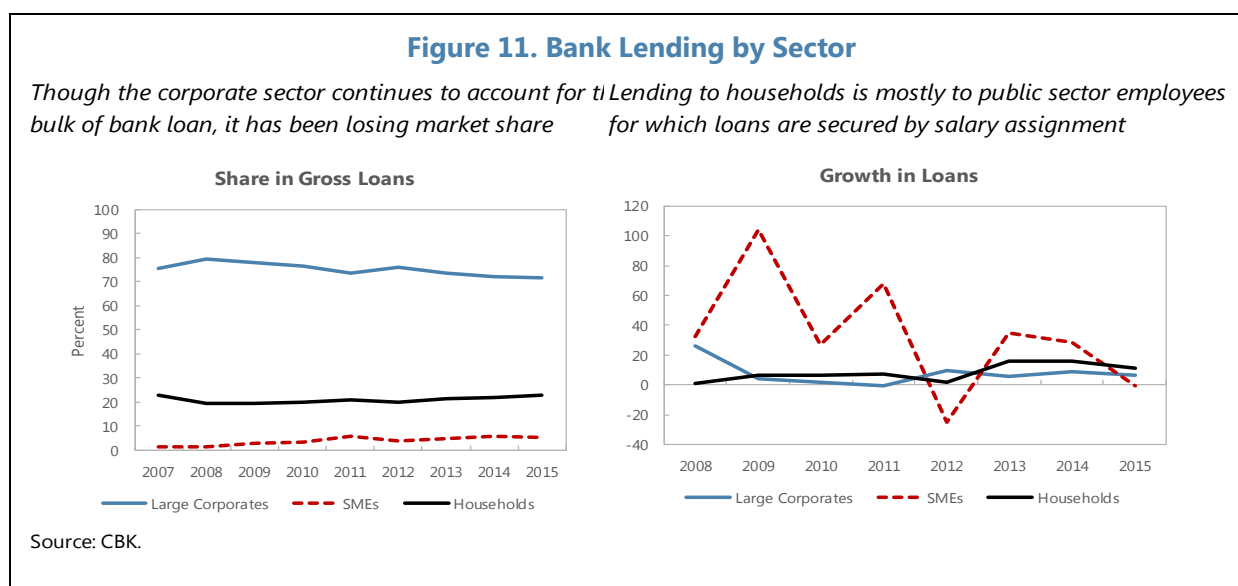
Sources: CBK, IFS.

16. Dividends from sustained financial sector reforms were also an important factor. The Central Bank of Kuwait (CBK) continued to implement elements of Basel III for local Banks. Building on already introduced regulations—additional Tier 1, Tier 2 and leverage ratio—the CBK continued to increase the Common Equity component of Tier 1, increased minimum CAR, implemented two new liquidity standards (the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)) and the framework for domestically systemically important banks (D-SIBs). The CBK also continued to enhance stress testing capabilities, introduced corporate governance frameworks and consumer

⁶ The CBK also increased its Discount Rate (CBDR) by 25 basis points to 2.25 percent. The increase in policy rates pushed up the average interest rate on loans of commercial banks, after calculating the margins above the discount rate allowed by CBK of 3 percent for customer loans and 4 percent for commercial lending, to be between 5.25-6.25 percent.

protection frameworks while advancing the efforts to strengthen resolution and crisis management frameworks for banks.

17. Banks, on their part, continued to enhance their risk management. The banks have been proactive in provisioning for impaired loans and writing off the loans from their books while continuing recovery efforts. They have also been raising capital in international markets to meet Basel III compliant tier-1 securities and, in selected cases, to reduce maturity mismatches given the increasing shift to project financing. Since the Global Financial Crisis, banks also reallocated credit in favor of households, mostly public sector employees, for which the loans are secured by salary assignment.



18. Structural and other coincidental factors also contributed. A recovery in government entities deposits helped ease emerging pressures in money markets and moderated the impact of increased government borrowing. The stable employment conditions for Kuwaiti nationals supported household asset quality.

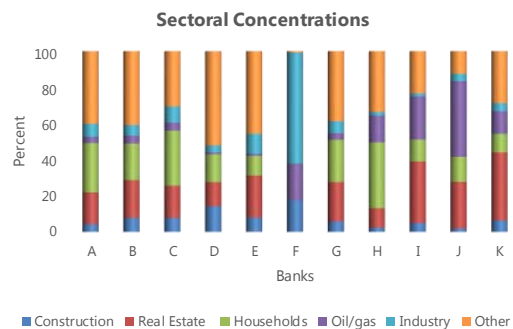
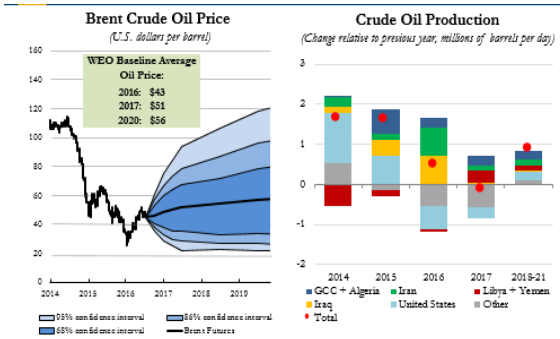
D. How Would Sustained Low Oil Prices Affect Kuwait's Banking System?

19. Kuwait's banking system is well-positioned to withstand oil price related macro shocks, though there are some downside risks. The gradual approach to fiscal consolidation combined with increased capital expenditure under the development plan will support nonoil GDP growth, credit conditions, bank profitability and internal capital generation. Banks have also enhanced their loss absorption capacity by building up capital buffers and provisions, and supervision is strong. Downside risks, nevertheless, remain owing to uncertainties about the trajectory of oil prices, high loan concentrations and the banks' significant exposures to cyclically sensitive real estate as well as the confidence driven equity markets. Slowing deposit growth could also force banks to rely on higher cost wholesale funding to support credit growth.

Figure 12. Oil Price Trajectory and Concentrations in the Balance Sheets of Kuwait Banks

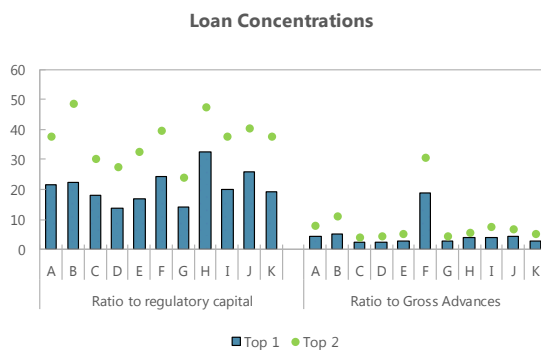
Oil prices are expected to remain low, but there is also uncertainty about the oil price trajectory

Bank balance sheets exhibit concentrations to cyclical sensitive sectors



Loan concentrations to single borrowers is high

Deposits are also concentrated, although these are mostly to government related entities



Sources: CBK, Bloomberg, and IEA.

The Macro Financial Outlook

20. Kuwait’s current macroeconomic outlook is expected to support financial sector growth and stability. Even as oil prices stay low, project implementation under the development plan is expected to support a gradual recovery in nonoil GDP and, therefore, provide a favorable operating environment for banks that provides ample business opportunities. This is supported by the large accumulated financial buffers and low debt.

21. The financial system is, nevertheless, exposed to a number of domestic and external risks, that entail important policy trade-offs. Reform setbacks, a slow DP implementation or a further sustained drop in oil prices could result in slower growth and thereby adversely impact asset growth and quality. Monetary policy normalization in the US monetary policy, which would have to be accompanied by higher policy rates in Kuwait, could increase funding costs for borrowers. On the other hand, allowing a deviation from US rates would expose Kuwait to capital outflows, which could

also tighten domestic liquidity conditions and increase domestic funding costs. Also, as some of the countries in which Kuwait banks have expanded are facing an economic slowdown and/or increased security risks, some asset quality deterioration can be expected from cross border exposures.

Resilience of the Banking System to Macro Shocks

22. Stress tests of the banking system undertaken in 2015 pointed to a banking system that is resilient to shocks although, under a severe stress scenario, some banks may require additional capital injections. Fayad (2015) employed a system GMM dynamic panel approach to assess the macroeconomic determinants of NPL, and found that nonoil GDP, real estate prices and equity prices are important drivers of NPL in Kuwait. Sensitivity analyses to shocks in these sectors were thereafter simulated for the period covering 2015 – 2017, based on data for 7 banks that collectively accounted for over 80 percent of the banking system assets. The results showed that, under the moderate scenario, the aggregate CAR would remain above the minimum capital but under the severe stress scenarios, some of the banks would become undercapitalized.⁷

23. The current stress tests build on Fayad’s work and extends the analysis to cover all the 11 banks with the aim to identify the credit and liquidity risk events that pose the most stability risks for Kuwait’s financial system. For credit risks, Table 1 below presents the plausible shocks assessed and the potential impact on bank capital based on end 2015 data, without attaching probabilities for the stress events occurring. In each case, the capital of banks is reduced by the amount of provisions needed to cover the NPLs generated under the stress scenario. Underlying collateral or subsequent year’s profits that potentially can be generated from continued growth in credit and non-interest income (such as fees and commissions) are not included, thus the results are static and not dynamic. For liquidity risk, Table 2 presents the Liquidity Coverage ratio (LCR) and the Net Stable Funding (NSR) ratio calculated by the CBK.

24. The results corroborate earlier findings that Kuwait’s banking system is resilient, but they also show that loan concentrations are a source of vulnerability. A migration of NPLs across the buckets to loss status has little impact on banking system stability because of the small size of the NPLs relative to capital and provisions. A deterioration of 10 percent of loans in the individual sectors also has a limited impact, except for the real estate and construction where one bank could see its CAR fall below 8 percent because of its sizeable exposure to the sector.⁸ The default of the single largest borrowers could erode the CAR in one bank to below the 13 percent statutory minimum but a default of the two largest borrowers would result in 6 banks falling short of the minimum CAR requirements. A deterioration in currently performing loans begins to affect banks when it reaches 5 percent, in which case it could erode capital for 4 banks to below the minimum. These results suggest a resilient banking system given the severity of the shocks and the

⁷ The moderate scenario assumed declines in non-oil GDP of -4.7, equity price drop of -22.6 and a real estate price drop of -20 percent. The severe shock simulated a fall in nonoil GDP of -8 percent, equity prices, at about -58.7 percent, and real estate (investment) price drop of 30 percent.

⁸ The stress results for the risk from the real estate, however, do not provide a complete picture to the extent that it does not take into account potential losses from real estate collateral or investments in the sector, particularly for the Islamic banks.

fact that the aggregate capital remains above the statutory minimum while the capital of the banks that become undercapitalization remains above the Basel minimum of 8 percent, with one exception.

Table 1. Credit Risk Stress Test Results										
AGGREGATE CAPITAL ADEQUACY RATIOS (CAR)										Impact on CAR
	Total	Sub-Groups by Ownership Type				Total	Distribution of Banks by Sub-Groups			
	Local Banks	Domestic Conventional	Specialized	Domestic Islamic Bank	No. of banks falling below 13 percent	No. of banks falling below 8 percent	Domestic Conventional	Specialized	Domestic Islamic Bank	
PRE SHOCK	17.1	16.6	46.9	17.0	0	0	0	0	0	0
POST SHOCK										
Concentration Risk (Single Obligor)										
Top 1 borrower defaults	15.1	14.4	40.0	15.3	1	0	0	0	0	1
Top 2 borrowers default	13.4	12.5	34.8	14.1	6	0	4	0	0	2
Deterioration in the performing loans										
5 Percent	14.2	13.7	45.3	14.2	4	0	2	0	0	2
Sectoral Concentration										
10 percent default (real estate, construction)	15.4	15.1	46.3	15.2	1	1	0	0	0	1
10 percent default on exposure to Oil companies	17.0	16.5	46.2	17.0	0	0	0	0	0	0
10 percent default on exposure to ICs	16.9	16.5	46.9	16.8	0	0	0	0	0	0
10 percent default on exposure to trade	16.4	16.0	46.9	16.4	0	0	0	0	0	0
10 percent default on exposure to industry	16.7	16.2	44.8	16.7	0	0	0	0	0	0
Migration of NPLs										
Special mention deteriorates to substandard	17.1	16.6	46.9	17.0	0	0	0	0	0	0
Substandard become doubtful	17.1	16.6	46.9	17.0	0	0	0	0	0	0
Doubtful become loss	17.1	16.6	46.9	17.0	0	0	0	0	0	0

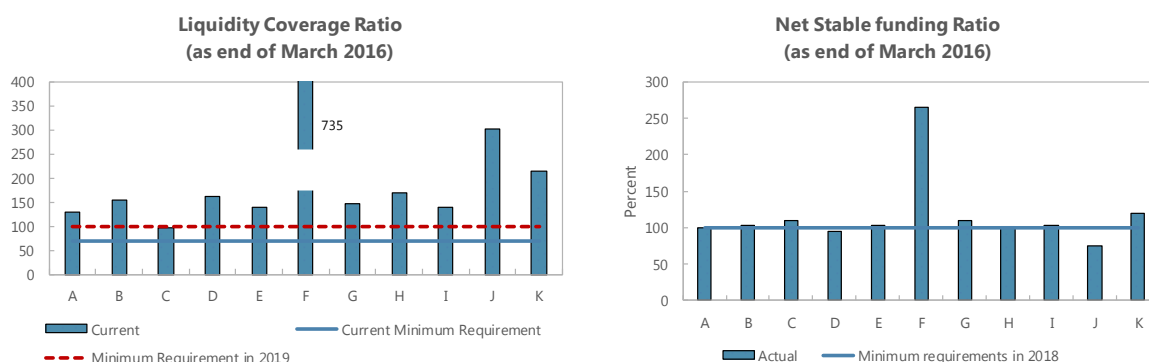
Source: IMF staff calculations.

25. Kuwait's banking sector also exhibits resilience to liquidity shocks, despite the high concentrations in the deposit base. The banking system's high liquidity coverage ratio (LCR) suggests that banks have an adequate stock of unencumbered high quality liquid assets that can be easily converted into cash to meet their liquidity needs over a 30 calendar day liquidity stress scenario. Similarly, the Net Stable Funding Ratio (NSFR) point to a sustainable maturity structure of assets and liabilities and the outliers are for a recently established bank and an industrial bank. As per Figure 12, deposit concentration is very high with one and two depositors respectively accounting for 10 and 20 percent of total deposits for most banks. However, the liquidity risk is mitigated by the fact that most of these deposits belong to public institutions with abundant cash-flows and the government has demonstrated a willingness to support the banks' liquidity by maintaining or increasing these deposits in periods of stress.

Figure 13. Resilience to Liquidity Risks

All banks maintain an LCR above the statutory minimum of 70 percent and most are above 100 percent

The NSFR also point to a sustainable maturity structure of assets and liabilities



Source: CBK.

Prudential and Liquidity Management Frameworks

26. Financial stability risks posed by a low oil price environment are further mitigated by the strong regulatory and supervisory framework adopted by the CBK. Significant advances have been made in aligning prudential frameworks with international standards, adopting risk based supervision (RBS), implementing consolidated supervision, and aligning supervisory processes with Basel III regulatory reforms related to capital, liquidity, and the Domestic Systemically Important Banks (D-SIB) framework. In particular:

- *Solvency risk:* Kuwait's minimum capital requirements are more stringent, being 2.5 percentage points higher than the Basel III guidance with full phase-in required by December 2016 (as compared to Basel III's Jan-2019 deadline).
- *Credit and concentration risk:* A credit registry, which facilitates banks' ability to assess borrower credit worthiness, was established following the passage of the law in 2001 and is operational. The concentration of household loans to public employees—for which job security is high and banks' practice of salary assignment—also reduce credit risk from households. Loan classification and provisioning requirement are stringent. The CBK also applies a Large Exposure (LE) limit of 15 percent of capital, which is more stringent than the Basel LE limit of 25 percent.
- *Liquidity risk:* Implementation of Basel III has boosted liquidity risk management. Banks in Kuwait are required to comply with five liquidity indicators, including the Liquidity Coverage Ratio (LCR),⁹ a Loan to Deposit ratio, limits on maturity mismatches, a regulatory liquidity ratio of 18 percent and Net Stable Funding ratio. The CBK also offers a Shari' ah compliant Lender of Last Resort (LOLR) facility to Islamic banks through the use of Tawarruq based on commodity

⁹ The main objective of the Liquidity Coverage Ratio (LCR) is to promote the short-term resilience of the liquidity risk profile of banks by ensuring that they have sufficient level of high-quality liquid assets (HQLA) to survive a significant stress scenario lasting for a period of up to 30 days.

Murābahah instrument. The government has capacity to support banking system liquidity and has demonstrated a willingness to support banks, including through an increase in deposits of government entities in commercial banks. While there is no formal liquidity forecasting framework, the supervision department closely monitors deposit trends in individual banks.

- *Systemic risks:* Considerable progress in managing systemic risks has been made with the introduction of macroprudential tools. Kuwait has made great use of macroprudential tools, including the Loan to Value ratio (LTV) applied to mortgages for second homes for investment in residential areas, a maximum KD70,000 limit on bank lending for primary homes which cannot be mortgaged by law, and debt to income ratio to help reduce leverage among households.
- *Risk identification and monitoring:* CBK continues to strengthen its stress testing framework which helps identify emerging risks.

27. The limited diversification of the economy, however, translates into loan concentrations and common exposures. These include sectoral concentrations and common exposures to real estate and households, single obligor loans to family-owned companies that operate across sectors and concentrations to big companies that are financed through syndicated loans. There are also concentrations in collateral in real estate and to some degree, equities. These concentrations could lead to spikes in NPLs while the common exposures increase risk correlations across the banking system and therefore systemic risks. Conglomerate and complex structures of some banks could, also, render risk identification a challenge, including in particular for Islamic banks that include nonfinancial corporations in their groups.¹⁰ A liquidity forecasting framework would help the CBK better anticipate possible liquidity shocks.

28. Remaining regulatory gaps also have potential to compound risks. Financial sector initiatives have focused more on prevention but reforms to mitigate losses once the risk has materialized have been slower. In particular, the slower progress in instituting debt recovery frameworks (insolvency regimes, secondary debt markets and Asset Management Companies) potentially increase Loss Given Default (LGD). Moreover, while macroprudential measures are in place, a formal framework for operationalizing the measures is yet to be established. In the absence of a formal framework for activation, the effectiveness of the measures could be reduced if developments and innovations in the financial industry result in products not covered by the measures. The measures, such as the LCR, could also have a pro-cyclical effect if not timely adjusted in line with emerging liquidity conditions.

Resolution and Crisis Management Frameworks

29. Efforts to strengthen resolution and crisis management frameworks are ongoing. This includes a special resolution regime for banks, deposit insurance scheme and arrangements for

¹⁰ Islamic banks are allowed to invest in fixed property while conventional banks are not and the presence of subsidiaries that are outside the regulatory perimeter presents an important challenge.

Emergency Liquidity Assistance (ELA). Arrangements for Technical cooperation with the IMF in these areas are advanced.

30. A special resolution regime for banks is under consideration. The authorities are making advances in developing a resolution framework that will be finalized with assistance of IMF technical assistance. All banks, including Islamic banks are, currently, subject to bankruptcy law that applies to all legal entities. Thus far, no Islamic bank has been liquidated, either voluntarily or compulsorily. Reforms are ongoing to strengthen the insolvency regime in collaboration with the World Bank, but these will need to be accompanied by reforms to establish commercial courts and ensure availability of judges with expertise in commercial disputes.

31. Deposits are currently covered by the blanket guarantee introduced in the aftermath of the GFC. In March 2009 the CBK introduced the Financial Stability Law (FSL), which was developed to support domestic financial institutions – primarily ICs – in distress. The blanket guarantee provides unlimited coverage, both for the insured amount and with respect to the type of deposits covered—ie., wholesale, retail, foreign, domestic, conventional and Islamic banks. The blanket guarantee is not backed by an explicit funding arrangement or infrastructure for pay out. The authorities are considering ways to reform the blanket guarantee to improve the incentive structure in the banking sector and limit the potential fiscal impact.

E. Conclusion and Policy Options

32. Kuwait's financial sector performance is interwoven with the oil price cycle, but prudent macro and financial sector policies have facilitated banking system stability. Due to Kuwait's heavy economic dependence on hydrocarbons coupled with the domestic focus of its banking system, deposit and credit growth have tended to move in tandem with the oil price cycle. However, during the recent oil price shock, financial buffers, accumulated in periods of high oil prices, have provided the policy space to support economic growth through measured fiscal adjustment and growth-enhancing capital expenditures, which has supported asset quality, business opportunities and bank profitability.

33. Nonetheless, Kuwait's financial system is not immune to risks from a sustained period of lower oil prices. A protracted period of lower oil prices, should it constrain public expenditures and weaken nonoil GDP growth, could potentially set in motion unfavorable macro-financial dynamics that increase credit and liquidity risks. The likelihood of such an event is limited in light of the government's large buffers that is available to support growth and the willingness to use the resources to minimize financial stability. However, if it did happen, vulnerabilities in bank balance sheets, particularly those related to deposit and loan concentrations and common exposures, could amplify the financial stability impact. In selected cases, complex conglomerate structures could affect timely identification of risks.

34. Continued enhanced surveillance will be critical for the timely identification of risks and timely policy responses. The efforts to strengthen stress testing techniques, the currently stepped up efforts to monitor deposit trends and the monitoring of restructured loans augur well for the early identification of financial stability risks. Enhanced monitoring of liquidity risk at the

system wide level will also be critical and to this end strengthening the liquidity forecasting framework is key. The completion of the Early Warning Indicators, including the real estate prices, and application of other risk identification techniques to complement stress testing, such as the balance sheet approach, will help to more comprehensively identify risks. Data on household indebtedness and corporate earnings will help identify emerging risks in the balance sheets of corporates and households.

35. Ongoing efforts to close remaining regulatory gaps will contribute to sustained financial stability. Individual capital ratios are a useful measure for addressing concentration risks in loan portfolios of individual banks and can provide incentives for the banks to address concentration risks, but in the case of Kuwait, the capital requirements for banks are already high. Reducing deposit concentrations would contribute to more sustained stability and banks should seek to diversify their funding structures. Further, while great advances have been made in strengthening risk prevention aspects of regulation and supervision—micro and macroprudential regulations, credit registries and stress testing—additional reforms to strengthen insolvency regimes would help minimize losses in the event of a default and safeguard fiscal resources. Strengthening the frameworks for resolution, crisis management, deposit insurance and emergency liquidity assistance, would also help facilitate orderly resolution, if banking system stress were to emerge. Banks with complex conglomerate structures that include non-financial corporations warrant further review to ensure that their corporate structures lend themselves to effective supervision.

36. Macroprudential policies could benefit from further upgrades. A formal framework for operationalizing macro prudential measures, including a formal decision making process would help in activating the measures and in ensuring that the measures do not amplify risks. Regular reviews of macroprudential measures against their objectives from time to time would be useful in ensuring that market developments do not weaken the effectiveness of the instruments.

37. Sound macroeconomic policies and structural reforms are essential for long term and sustained financial stability. Gradual fiscal adjustment that limit the effects of low oil prices on the nonoil economy will help mitigate potential credit risk for banks. Financing strategies that balance the government financing needs, minimize private sector crowding out and promote market development will support financial stability. Finally, since loan concentrations are related to the limited economic diversification, structural policies that help diversify the economy will over time promote financial stability on a more sustained basis.

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ENHANCING KUWAIT'S GROWTH PROSPECTS IN A LOW OIL PRICE ENVIRONMENT¹

A. Introduction

1. Kuwait is one of the most oil-dependent members of the Gulf Cooperation Council (GCC). Even after the significant drop in oil prices experienced in recent years, the hydrocarbon sector still accounted for about 90 percent of total exports, 66 percent of fiscal revenues and 60 percent of real economic activity in 2015 (Figure 1).²

2. As a result, economic performance has been highly susceptible to oil price swings. Kuwait's per capita income has over the years moved in tandem with global oil prices. During 2003-14, high oil prices allowed the government to support growth by ramping up spending and providing public sector jobs to an expanding national labor force, while still saving a large part of oil revenue and accumulating significant fiscal and external buffers. However, the collapse in global oil prices since mid-2014 has adversely affected Kuwait's external and fiscal accounts and has led to a softening in nonoil real GDP growth.³

3. The prospects of sustained low oil prices are now challenging the traditional growth and job-creation model. The current model has been characterized by high reliance on oil revenue and related government spending to drive economic growth and employment for nationals. At the same time, the private sector, which has to a large extent been driven by government contracts and spillovers from the oil boom, has relied heavily on foreign labor. With the current low oil prices expected to persist, Kuwait has to adjust to a new reality. This entails gradually increasing fiscal savings to reduce fiscal vulnerabilities and continue to save for future generations. Fiscal consolidation, in turn, is bound to slow growth. A key policy challenge is therefore to adjust the fiscal position at the least cost to economic activity. At the same time, in a constrained budgetary environment, generating higher sustainable growth, creating jobs for a growing young national population, and reducing exposure to the oil price cycle will require addressing labor market inefficiencies, encouraging private sector development and diversification into nonoil tradable sectors.

4. This paper aims to identify and prioritize policies to support growth in a "lower-for-longer" oil price environment. It is organized as follows: section B outlines recent growth developments in Kuwait; section C investigates the impact of fiscal consolidation on growth;

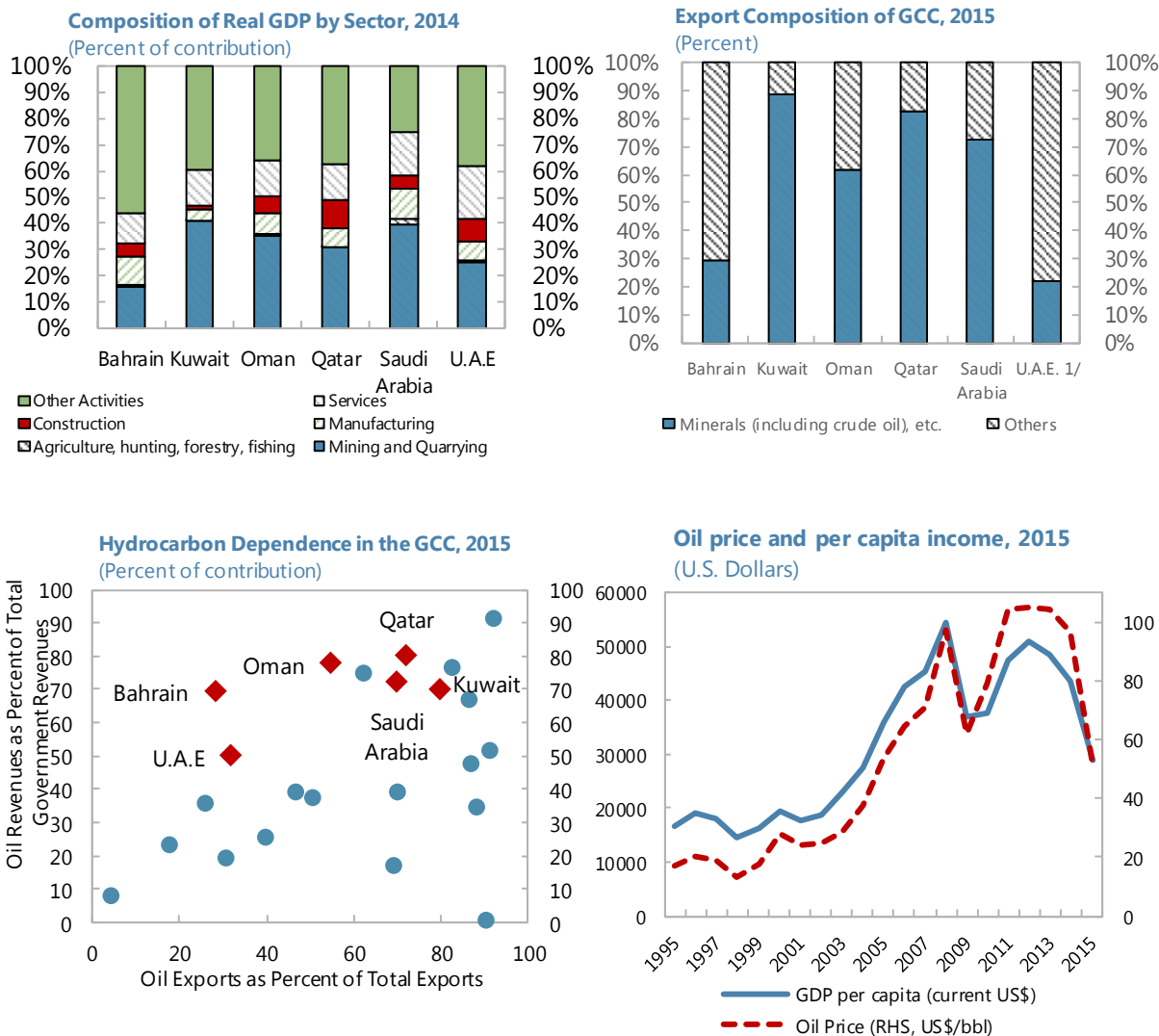
¹ Prepared by Botirjan Baltabaev, drawing extensively on a paper prepared by IMF staff as background for the 2016 GCC ministerial meeting (IMF, 2016).

² Based on a definition of oil GDP (at market prices) that excludes import duties less subsidies.

³ Specifically, the current account surplus plunged from 33 percent of GDP in 2014 to just over 5 percent in 2015; while the fiscal balance is now posting deficits of the order of 17.7 percent of GDP (2015/16); and, although large fiscal buffers have allowed the government to adjust spending at a gradual pace, nonoil growth slowed from 5 percent in 2014 to 3½ percent last year. The underlying fiscal balance—which includes revenue transferred to the Future Generations Fund (FGF) and investment income—has also swung into a small deficit as a result of dwindling oil revenue.

section D discusses longer term sources of growth; section E identifies areas where structural reforms can help boost growth and job creation; and section F concludes.

Figure 1. Hydrocarbon Dependence



Sources: United Nations Statistics Division; World Bank; and country authorities.
1/ UAE data are 2014.

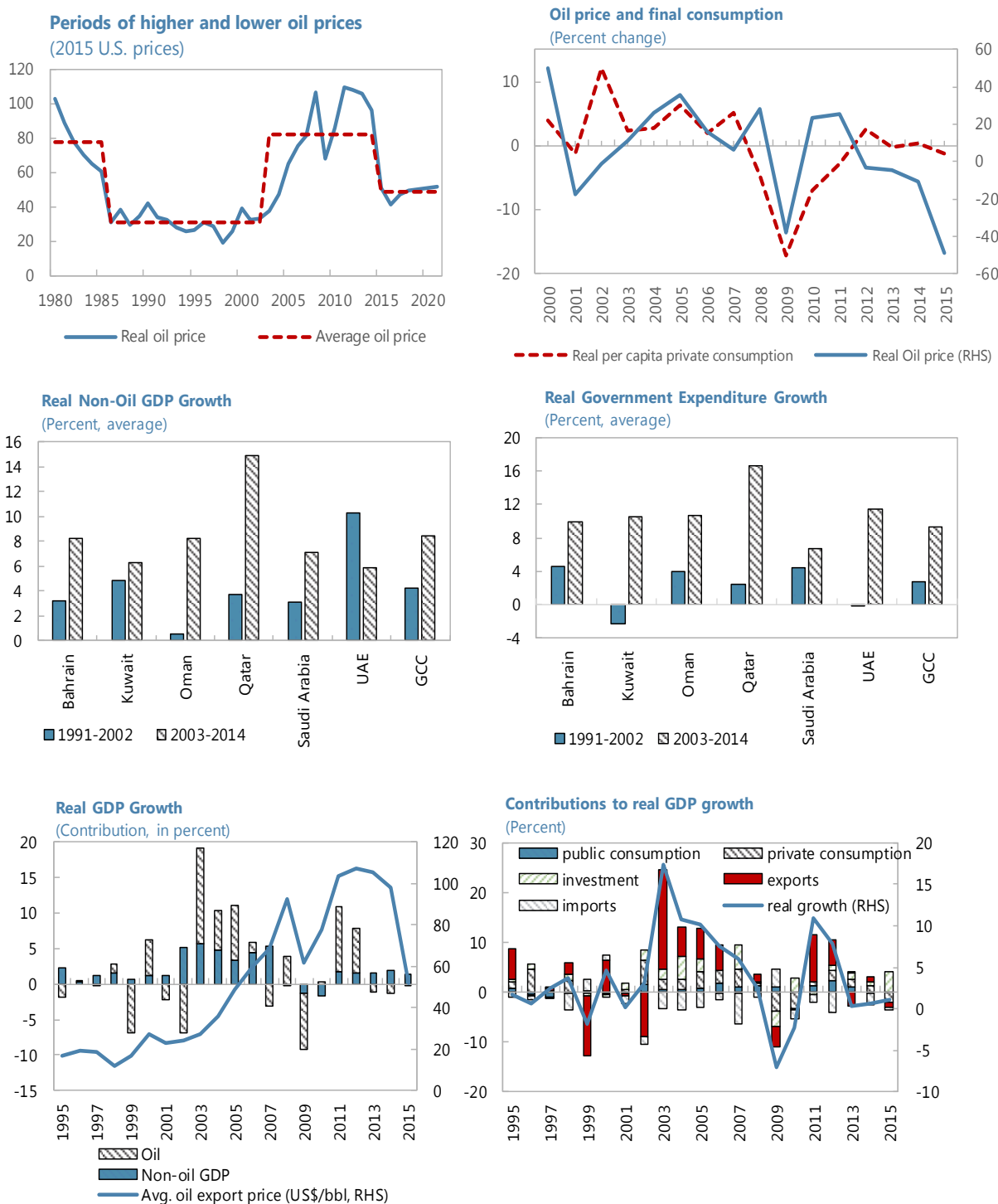
B. Kuwait's Growth Performance and Oil Prices

Kuwait's nonoil oil growth performance has in the past been closely linked to oil price cycles. In periods of high oil prices, growth has been supported by oil-revenue financed fiscal expansions and rising consumer confidence. In the current environment, there is a risk that nonoil growth will be weaker as fiscal spending now needs to be adjusted gradually.

5. **Kuwait has faced prolonged periods of lower and higher oil prices in the past few decades.** The fall in oil prices in 1986 marked the beginning of a long period of low oil prices, particularly when compared to prices in previous years (Figure 2). The last period of lower (higher) oil prices lasted broadly between 1986-2002 (2003-14). Most recently, global oil prices have fallen since mid-2014 and are projected to remain near present levels for the foreseeable future.
6. **Nonoil growth has been higher during periods of higher oil prices, supported by higher public spending.** Average annual oil prices during 1991–2002⁴ and 2003–14 were \$29.5 and \$82.3 per barrel, respectively. When oil prices were lower (1991–2002) average annual nonoil GDP growth was 4.9 percent, whereas when oil prices were higher (2003–14) average nonoil growth reached 6.3 percent per year. Higher oil prices helped the government finance rapid increases in spending—the average annual growth rate in real government spending was 10.5 percent during 2003–14. When oil prices were lower (1991–2002), the average growth rate of real government spending was -2.3 percent, contributing to lower nonoil growth.
7. **Oil prices have also affected private consumption.** Historically, changes in real oil prices also affected real per capita private consumption growth, likely through fluctuations in consumer confidence. When oil price growth was high through 2003–2007, private consumption growth was strong. During the global financial crisis period, the large drop in oil prices led to significant decrease in real per capita private consumption growth.
8. **Compared to the pre-crisis period, per capita private consumption growth has been weak recently.** Following the most recent drop in oil prices, the growth of real per capita private consumption turned negative in 2015. However, compared to the extent of the decline in oil prices, the slowdown looks relatively mild, likely due to the supportive fiscal policy stance. Given the expected protracted softness in oil prices and the need to adjust fiscal policy to the shock, the weak real per capita private consumption growth will likely persist going forward, weighing on the overall growth in the economy.

⁴ Due to data constraints, growth analysis starts from 1991, reducing the lower oil price period to 1991–2002 from 1986–2002.

Figure 2. Kuwait Growth and Oil Prices



Sources: EDSS; Haver; Country authorities; and IMF staff calculations.

C. Short-term Growth Prospects in Light of Fiscal Consolidation Needs

Faced with the prospect of lasting lower oil prices, Kuwait has to adjust fiscal policy to a new reality. This entails gradually increasing fiscal savings to reduce fiscal vulnerabilities and continue to save for future generations. Fiscal consolidation will likely slow growth. A key policy challenge is therefore to adjust the fiscal position at the least cost to economic activity—through low multiplier tax revenue and current spending measures while making room for additional high-multiplier growth-enhancing capital outlays.

9. The existing literature has investigated extensively the growth impact of fiscal policy.

Blanchard and Perotti (2002), Mountford and Uhlig (2009), and Ilzetzki et al (2013) provide estimates of fiscal multipliers for advanced economies, while Kraay (2012) and Hory (2016) estimates are for emerging markets. A literature review by Batini et al. (2014) finds fiscal multipliers to be lower in emerging and low income countries than in advanced economies — for instance due to inefficiencies of government spending and greater leakages through imports in smaller and more open economies. Short-term spending multipliers for advanced economies range between 0.6 and 1.4 and for emerging markets between 0.2 and 0.5.

10. For GCC countries, estimates of fiscal multipliers are larger for capital than for current spending.

Espinoza and Senhadji (2011) and Cerisola et al. (2015) provide estimates of fiscal multipliers for the GCC, with short-term (one year) spending multiplier around 0.3 and medium-term (three years) multipliers between 0.3 and 1.4, with larger estimates for capital spending than for current spending (Table 1). Updated estimates using expanded data up to 2015 produce multipliers of similar magnitude (IMF, 2016). In line with the previous papers, multipliers are larger for capital than for current spending. The short-term multipliers are 0.4 for capital spending and 0.3 for current spending. While current expenditure seems only to affect economic activity in the short term, the medium-term impact of capital spending is found to be larger. The current spending multiplier is estimated at 0.3, with no statistically significant effects on growth beyond one year; capital spending multipliers are estimated at 0.4 and 1.6 for the short and medium-term impact, respectively. The relatively wide range of estimates suggests that the impact of fiscal consolidation on growth could vary across countries depending on its composition — current versus capital spending as well as the type of spending on growth.

Table 1. Estimated Multipliers for the GCC, 1990–2015¹

	Capital Spending	Current Spending
IMF 2016		
<i>Multipliers (1990 - 2015)</i>		
Short-term	0.4	0.3
Medium-term	1.6	0.3
<i>Multipliers (2008-2015)</i>		
Short/Medium-term	0.0	0.0
<i>Espinoza & Senhadji (2011)</i>		
Short-term	0.2 – 0.3	0.2 – 0.4
Medium-term	0.6 – 1.1	0.3 – 0.7
<i>Cerisola et al. (2015)</i>		
Medium-term	1.4	0.7

Source: Staff estimates.

¹ The fiscal multiplier indicates the amount non-oil GDP would change if government spending changes by one unit.

11. Looking ahead, as Kuwait adjusts its fiscal position to the lower oil price environment, nonoil growth is likely to be affected. While large financial buffers and low debt provide space to smooth fiscal adjustment over time and limit the impact of consolidation on economic activity, some impact of fiscal retrenchment on nonoil growth will take place. At the same time, large financing needs in the years ahead may affect domestic liquidity, private sector credit, and investment if the financing mix is too heavily focused on domestic markets.

12. However, a number of actions can be taken to mitigate the impact on growth:

- **Adjustment should be designed to fall as much as possible on items with limited impact on growth.** This entails focusing on low-multiplier spending and revenue measures—such as reducing subsidy bills or other transfers to high income individuals—while making room for growth-enhancing (high-multiplier) capital spending.
- **It would be important to complement these measures with reforms aimed at improving spending efficiency.** As regards public investment, for instance, growing empirical evidence suggests that more efficient capital expenditure leads to a stronger relationship between investment and growth (Gupta et al., 2014). Efficient public investment requires public investment management frameworks that can: (i) plan sustainable levels of investment—including factoring in maintenance and other recurrent costs from a higher domestic capital stock; (ii) evaluate and select the projects with highest impact, particularly when resources are limited or bottlenecks prevent efficiency; and (iii) implement projects on time and in a cost-effective way, including through sound procurement and monitoring systems (IMF 2015).
- **As fiscal adjustment helps gradually reduce financing needs, the government financing mix should be carefully designed.** While the development of domestic government debt markets will eventually help develop the corporate market, too high reliance on domestic banks to fund the government deficit may lead to crowding out of private sector investment and make implementation of Kuwait’s development plan more difficult (see below). The government will need to strike a balance between these objectives (see companion paper on fiscal financing options).

D. Long-term Sources of Growth

In the face of the new oil price reality and the negative fiscal impulse expected in the years ahead, Kuwait needs to boost potential growth by tackling the underlying sources of growth. Labor accumulation has been the major contributor to nonoil growth over the past years, followed by smaller contributions from TFP and capital. However, the contribution of TFP growth was lower during lower oil price periods, and projections going forward also point to lower levels, highlighting the importance of structural reforms to raise productivity.

13. Amid significant fiscal consolidation efforts, Kuwait faces the challenge of boosting potential growth. The growth model, characterized by reliance on oil and provision of jobs in the public sector for nationals, has delivered gains in economic and social indicators in the past. However, with oil prices expected to persist near present levels and the growth performance expected to be hampered by fiscal consolidation, there is a need to boost economic diversification

and sustainable growth in the nonoil tradable sector, which in turn, can help reduce exposure to oil price volatility and generate productive, private sector jobs for nationals.

14. Nonoil growth in Kuwait has in the past mostly been driven by labor accumulation.

Labor has been the main driver of nonoil growth during the last 25 years, regardless of whether oil prices have been relatively high or low. This was followed by TFP growth and capital accumulation (Table 2). Unlike in most other GCC countries, the contribution of TFP was higher while that from capital accumulation lower.

Table 2. Non-oil Growth in the GCC: Input Contributions 1/
Real non-oil GDP Growth and Breakdown into Labor, Capital, and TFP
(Growth rates in percent, contributions to growth in percentage points; median values)

	Average annual non-oil growth, percent	Average contribution to growth, percentage points			Fraction of non-oil growth accounted by labor and capital
		Labor	Capital	TFP	
Full Period, 1991 - 2014					
Bahrain	5.7	3.2	2.2	0.2	0.96
Kuwait	5.6	3.3	0.9	1.4	0.75
Oman	4.4	3.0	2.5	-1.1	1.26
Qatar	9.3	4.8	3.7	0.8	0.91
Saudi Arabia	5.1	1.8	2.0	1.3	0.74
UAE	8.1	5.0	1.8	1.2	0.85
GCC Average	6.4	3.5	2.2	0.6	0.90
Lower Oil Prices, 1991 -2002					
Bahrain	3.2	3.0	1.7	-1.5	1.47
Kuwait	4.9	4.0	0.0	0.8	0.83
Oman	0.6	1.6	2.1	-3.2	6.35
Qatar	3.7	1.1	1.7	0.9	0.75
Saudi Arabia	3.1	1.2	1.6	0.3	0.90
UAE	10.3	5.0	1.4	3.9	0.62
GCC Average	4.3	2.6	1.4	0.2	0.95
Higher Oil Prices, 2003 -2014					
Bahrain	8.2	3.5	2.7	2.0	0.76
Kuwait	6.3	2.7	1.7	1.9	0.69
Oman	8.2	4.4	2.9	0.9	0.89
Qatar	14.9	8.4	5.8	0.7	0.95
Saudi Arabia	7.1	2.3	2.4	2.3	0.67
UAE	5.8	5.1	2.2	-1.4	1.24
GCC Average	8.4	4.4	3.0	1.1	0.87

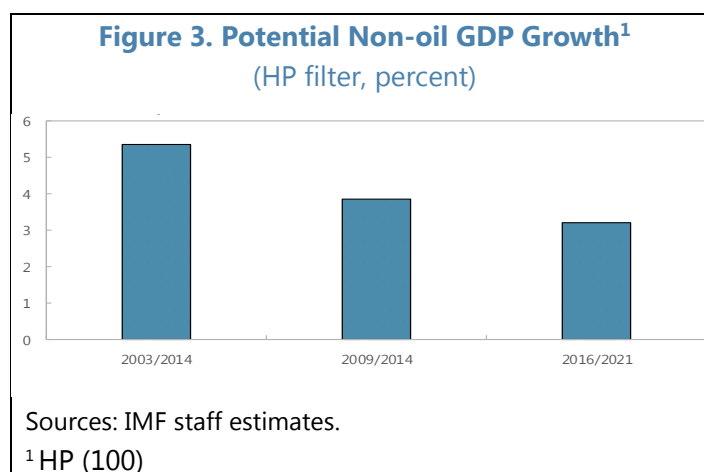
Source: IMF, WEO and staff estimates

1/ Labor's share in GDP is assumed at 50 percent. Labor shares of 40/60 percent increase/reduce TFP between 0.1-0.2 percentage points.

15. Growth and growth drivers performed better in Kuwait when oil prices were higher. As noted above, nonoil growth was higher when oil prices were higher, as compared to periods when prices were lower (Table 2). The favorable environment created by higher oil prices supported higher public and private investment as well as employment, which improved the contribution of capital and labor to growth. Higher oil prices also favored improvements in TFP, for instance, because higher public infrastructure investment led to lower production costs in the economy. The average TFP growth was more than the double, at 1.9 percent, during higher oil price periods as compared to lower oil price periods.

16. Looking ahead, potential nonoil growth is expected to fall over the medium-term.

Lower oil prices will negatively impact investment and reduce the rate of labor and capital accumulation, slowing down capital and labor contributions to growth. The positive magnitude of the slowdown may be estimated using a production function approach.⁵ While results are sensitive to assumptions, they generally anticipate lower potential growth over the medium term (2016–21) in the absence of reforms. Potential growth estimated using Hodrick-Prescott filters also suggest lower growth of 3.2 percent during 2016–21 (Figure 3), much lower than the potential growth of 5.4 and 3.9 percent per year during 2003–14 and 2009–14, respectively. This represents a significant slowdown in per-capita income growth and highlights the urgency of significant structural reforms to boost productivity.



E. Structural Reforms to Spur Growth and Job Creation

Declining TFP growth prospects call for major structural reforms. The current labor market structure is being challenged and needs overhaul. While the authorities' envisaged reform plans in the areas of privatization and PPPs are welcome, more needs to be done to ease bottlenecks to doing business and global competitiveness.

17. Structural reforms are key to private sector development, job creation and diversification prospects. Kuwait will need to reform its economy to create a dynamic private sector which can absorb the growing national labor force. This requires significant overhaul of labor markets and civil service hiring practices as well as elimination of impediments to doing business and enhanced private sector participation in economic activity. Structural reforms should be complemented by investments in areas where Kuwait lags behind peers in global competitiveness, which will eventually boost TFP.

⁵ Estimations are based on a standard Cobb-Douglas production function, and follow Mitra et al. (2015) in setting factor shares at 0.5.

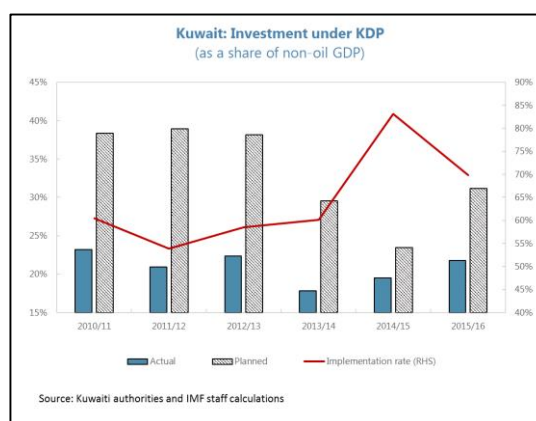
18. The Kuwaiti government has initiated several reforms to invigorate new engines of growth. The second Kuwait Development Plan (KDP) was approved in early 2015, following the first development plan which was only partially implemented (Box 1). The current KDP envisages to make significant investment into the real economy to boost public infrastructure while also involving the private sector in these activities. A key element of the KDP is the plan to boost public-private partnerships (PPPs) to finance investment projects worth US\$27.6 billion (24 percent of GDP), on the basis of the new PPP law adopted in 2014. Several large projects are featured in the development plan, including a new metro rail network for Kuwait City, rail network to connect with other GCC members and the extension of the Kuwait Airport.

19. The government has also announced a medium term reform agenda organized around six pillars: (i) rationalizing government expenditure and increasing nonoil revenue; (ii) modernizing the role of the state; (iii) promoting private sector development; (iv) encouraging citizens' participation; (v) making the labor market and civil service more efficient; and (vi) improving the business environment (Box 2). As part of the efforts to increase the private sector's and citizens' role in economic activity, several State Owned Enterprises (SOEs) are planned for privatization after the Amendment of the Privatization Law. These SOEs include the airports, the Port Authority, the Government Printing Press, power generation and distribution stations, several utilities, the activities of the Kuwait Petroleum Corporation, the postal system, wire and wireless communications, sewerage plants, and the management of government schools and hospitals.

Box 1. The Kuwait Development Plan (KDP)

In February 2015, the government approved the country's second five-year development plan that envisages to invest significant amount of funds (\$US 117.7 billion or 103 percent of GDP) in the economy. The current plan carries over 421 projects from the first development plan, that was not fully implemented and adds 92 new projects. The goal of the KDP is twofold: i) implement ambitious investment projects in core infrastructure, utilities, housing and oil and gas; and ii) pursue major economic reforms to support private sector development.

The investments implemented under the KDP will bolster the medium term growth outlook. In FY2015/16, the actual amount invested through KDP was around KD5.8 billion, about 45 percent higher than the previous year. The share of investments in non-oil GDP has also been rising since FY2012/13 and project implementation rates have improved recently. Strong public investment activity and improvements in project implementation are expected to continue over the medium term.



Box 2. Six-Pillar Reform Strategy

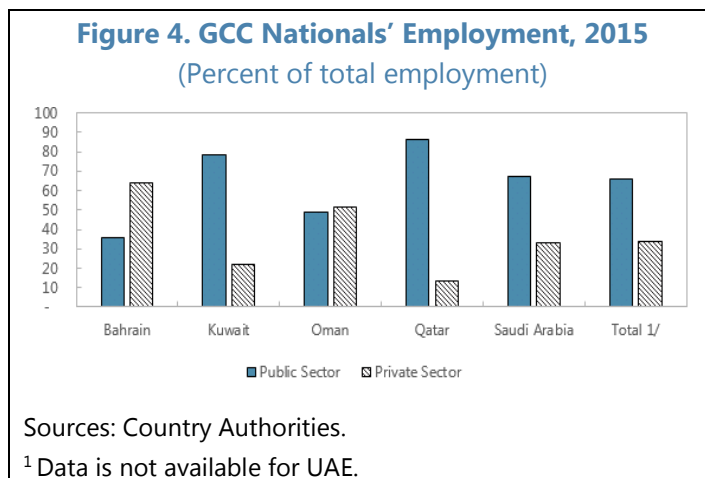
In early 2016, the government announced a comprehensive reform strategy to underpin medium-term fiscal adjustment, encourage private sector development and diversification, and create jobs for the growing national labor force. The strategy is organized around six-pillars: (i) rationalizing government expenditure and increasing nonoil revenue; (ii) modernizing the role of the state; (iii) promoting private sector development; (iv) encouraging citizens' participation; (v) making the labor market and civil service more efficient; and (vi) legislative and institutional reforms.

- *Rationalizing government expenditure and increasing nonoil revenue.* These envisage reducing the budget deficit over the medium term by raising nonhydrocarbon revenue (introducing a business profit tax and a VAT and raising the price of some government services) and curtailing expenditure through rationalization of government agencies' spending, further advancing subsidy reforms and reforming the pay structures.
- *Modernizing the role of the state in the national economy.* Measures in this area include encouraging and incentivizing the private sector to enter various production sectors; strengthening partnerships with the private sector and market forces and competition.
- *Promoting private sector development.* To increase private sector participation in economic activity, the government plans several reforms in areas, such as, the privatization of public enterprises; PPP projects; and soft financing for small and medium enterprises.
- *Encouraging citizens' participation,* which will ensure that the citizens become partners in enterprises offered through the PPP or privatization program.
- *Making the labor market and civil service more efficient.* The reform of the labor market and civil service system will be carried out over two years. In the first year, the authorities aim to conduct wage reform; labor force planning in the private sector; and upgrading of labor force competence. In the second year, the implementation of a performance evaluation system; training of national labor; and upgrading of competence in the public sector will be completed.
- *Legislative and institutional reforms.* These will cover: i) enhancement of the competence of public financial management in the government; ii) creation of a business environment that attracts private domestic and foreign investors; iii) tax administration development; iv) elevation of the rating of the Kuwait Stock Exchange to place it among the main emerging market indices during 2016-2017; v) enactment, amendment, and updating of legislation.

20. Three areas of structural reforms appear particularly central to the objectives of diversifying the economy, boosting productivity and private sector investment, and creating jobs for the growing national labor force.

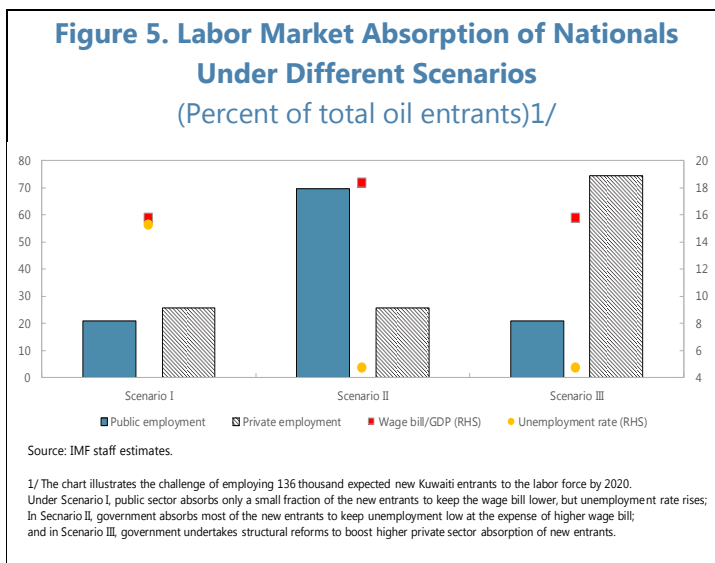
Making the labor markets and civil service more efficient

21. As in other GCCs, Kuwait’s labor market is characterized by the strong presence of nationals in the public sector. Despite strong growth in the nonoil sector during the period of higher oil prices, job creation for nationals in the private sector remained weak. This largely reflects labor market policies where public sector employment of nationals is used as a way to distribute the oil wealth among citizens, while the private sector labor demand has been fulfilled by imported labor (IMF (2013) and IMF (2014)). More than three quarters of public sector jobs are filled by the Kuwaiti nationals, while in the private sector they account for just over 20 percent (Figure 4).



22. The current model of public sector employment is unsustainable. Kuwait needs to adjust fiscal expenditures to low oil prices and, thus, faces a trade-off between achieving fiscal objectives, including through a careful management of the wage bill, potentially at the cost of higher unemployment if the private sector cannot hire new labor market entrants or absorbing them in the public sector at a higher wage bill cost (Figure 5).

This problem calls for speeding up labor market as well as structural reforms to boost private sector growth.



23. Labor market reforms and civil service reforms should aim at improving incentives for nationals to take up jobs in the private sector, including by setting expectations about the limited future availability of public sector jobs and tackling the inefficiencies that make these jobs more attractive (such as high wages and benefits). Reforms should also encourage the hiring of nationals by private sector firms by addressing the wage gap between expatriates and fostering an education system that reduces skill mismatches by training nationals in skills that are needed in the private sector.

Boosting productivity and stimulating private sector investment through privatization and greater use of PPPs

24. The authorities' plans for PPPs and privatization bode well for TFP enhancement.

The literature indicates that SOEs tend to be inefficient when compared to similar private sector enterprises. Some of the reasons for this inefficiency are inadequate management incentives and accountability structures. They are also rarely held accountable for their performance by line ministries. When SOEs incur losses, the government usually covers them, to protect employment of nationals (Sartawi, 2012). As part of the government's reform plans (Boxes 1 and 2), several SOEs and projects will be transferred to private hands through privatization or PPPs, which should improve their productivity. Existing studies indicate privatized firms increase their efficiency (Megginson and Netter, 2010), likely boosting overall TFP (Davis, 2000).

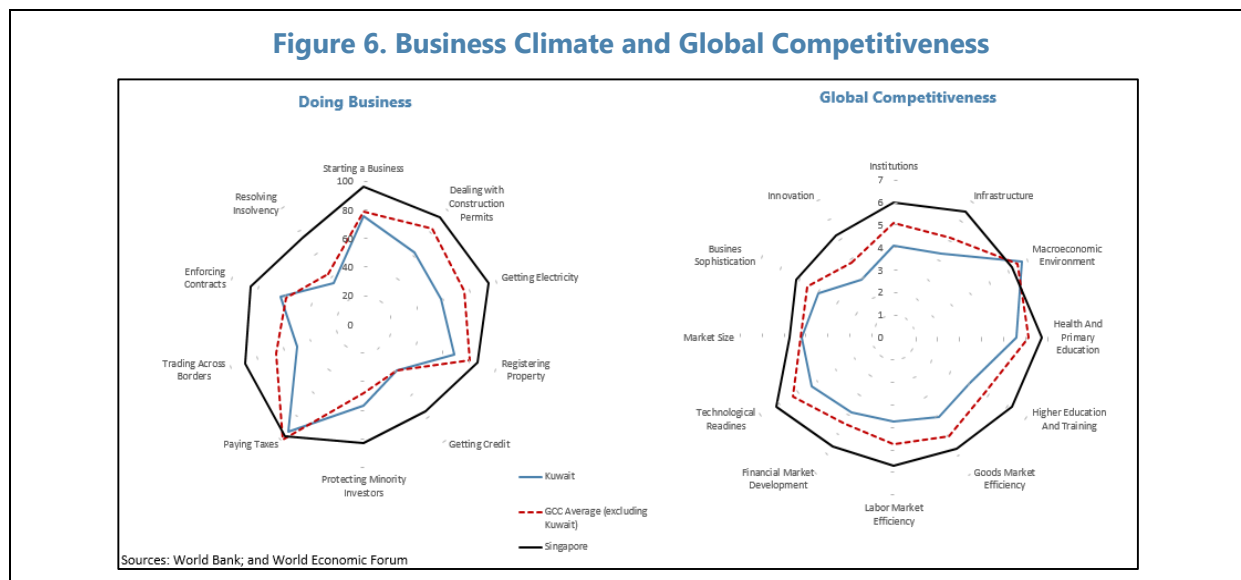
25. The authorities are advancing PPP and privatization reforms. Building on stronger legal and institutional frameworks, the government aims at a greater use of these options to enhance the role of the private sector in the economy and upgrade infrastructure. While the privatization program is still in its early stages, several Build-Operate-Transfer projects are in the pipeline. Continued progress toward establishing clear timetables, advancing preparatory work to strengthen underlying assets, and promoting a transparent environment that fosters competition and reduces hidden costs and contingent liabilities for the government will help stimulate private sector investment and boost productivity.

Accelerating the development plan implementation and improving the business climate

26. Timely implementation of KDP investment projects and economic reform is crucial.

The setbacks that affected the first KDP should be avoided and the project implementation under the current KDP should be improved to enhance the quality of infrastructure, one of the areas of concern in global competitiveness. This is also important for medium-term growth prospects, as the effect of fiscal consolidation will be milder thanks to strong capital spending and higher TFP associated with better public infrastructure.

Figure 6. Business Climate and Global Competitiveness



27. The analysis of structural indicators suggests significant potential from improving the business climate. Notwithstanding the caveats of the traditional cross-country indicators, the World Bank Doing Business and the WEF Global Competitiveness indicators display gaps in some areas between Kuwait and peer countries (Figure 6). While Kuwait performs well in terms of the macroeconomic environment, the country still lags on administrative procedures, such as, obtaining construction permits or registering properties, access to finance, and trading across borders. To ease some of these obstacles, the authorities have taken a number of steps, while also continuing to improve other areas. A National Fund was launched to improve access to credit to SMEs. More recently, the government opened the Kuwait Business Center, a one-stop window to facilitate administrative procedures for enterprises—with the aim of making it possible to obtain a new license within four days (instead of 45 days). They plan to open a similar facility for SMEs. Several initiatives are also envisaged in the Six-pillar plan, such as, the introduction of a Law on Insolvency and Creditors' Rights as well the Amendment of the Privatization Law. In order to create a diversified economy and a dynamic private sector that absorbs the growing labor force, these efforts should be stepped-up to remove the obstacles to doing business. Moreover, Kuwait needs to improve all areas to boost global competitiveness.

F. Conclusions

28. The lower oil price environment creates significant hurdles for growth. The current model has been characterized by high reliance on oil revenue and related government spending to drive economic growth and employment for nationals. With the current low oil prices expected to persist, Kuwait has to adjust to a new reality. Fiscal consolidation, in turn, is bound to slow growth. A key policy challenge is therefore to adjust the fiscal position at the least cost to economic activity. To do so, the government should use its large buffers to adjust gradually, focusing on expenditure and revenue reforms with a low impact on growth, and rebalancing spending toward capital expenditures. The latter's efficiency should be boosted through public investment management reforms.

29. With TFP growth expected to fall in a low oil price environment, structural reforms to boost productivity are key. Labor force accumulation has been the key driver of growth in Kuwait over the past years. The contribution of TFP and capital were stronger when oil prices were higher. In years ahead, their contribution is expected to fall as low oil prices are expected to persist. This calls for structural reforms not only to boost TFP growth but also to reinvigorate the new engines of the economy led by a dynamic private sector.

30. Structural reforms are central to the objectives of boosting productivity and private sector investment, and creating jobs for the growing national labor force. Three areas of structural reforms appear particularly central to the objectives of diversifying the economy, boosting productivity and private sector investment, and creating jobs for the growing national labor force. These include making the labor market more efficient by improving incentives for nationals to take up jobs in the private sector and for the private sector to hire nationals; boosting productivity and stimulating private sector investment through well-designed privatization and a greater use of PPPs; and accelerating the development plan's implementation and advancing reforms to improve the business environment.

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