Kuwait: 2015 Article IV Consultation Concluding Statement of the IMF

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The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board.

The decline in oil prices has adversely affected Kuwait's fiscal and current account balances and slowed growth in 2014/15. High financial buffers provide cushion to continue to support growth through public investment and smooth the needed fiscal adjustment over the medium term. Nevertheless, the government needs to implement gradual but sustained adjustment of current spending, focusing on reducing rigidities in the budget by continuing with subsidy reform and introducing wage reform, and improve the efficiency of capital expenditure to strengthen non-oil growth and ensure intergenerational equity. Reforms should be initiated without delay, especially in view of the risk of a further sustained oil price decline, with greater emphasis on labor market and other structural reforms to reduce the economy's dependence on oil and lay the basis for private sector-led growth.

The Central Bank of Kuwait has continued to strengthen regulation and supervision of the banking system to safeguard financial stability, and banks are in a strong position to weather the challenges of lower oil prices.

I. Recent Economic and Financial Developments

1. The economy continued to grow in 2014, albeit at a lower rate, reflecting some slowdown in investment activity. The estimated slowdown in non-oil sector growth to 3.2 percent in 2014 (4.2 percent in 2013), has been driven by moderating activity in a number of sectors, notably, in manufacturing, trade, electricity and water, and transportation sectors. The decline in oil production by 1.4 percent, due partly to the closure of a neutral zone oilfield in the latter half of 2014, reduced overall real GDP growth to zero. Average inflation increased slightly to 3 percent in 2014, and edged up to 3.3 percent in July 2015, driven mainly by housing rents.

2. Financial market conditions are subdued. Stock prices declined by 16 percent y-o-y at end-August 2015, reflecting global financial market volatility, and regional geopolitical and domestic economic uncertainties. The average value of real estate transactions has tended to exhibit considerable volatility, and a correction trend is not evident at this stage. Corporate sector profitability remained stable in the first half of 2015. Growth in banks' deposits and credit to the private sector edged down to 5.4 percent and 4.7 percent, respectively, in June 2015 (y-o-y). The central bank kept its discount rate, the key benchmark rate for lending, unchanged at 2.0 percent to help stimulate private sector credit.

3. The banking sector is well regulated and has shown resilience to the oil price shock. The sector had a capital adequacy ratio of 16.9 percent according Basel III definition, nonperforming loans ratio of 2.8 percent, and provisioning ratio of 172 percent on a consolidated basis at end-June 2015. Banks' return on assets and equity increased, respectively, to 1.1 percent and 8.9 percent (1.0 percent and 7.4 percent in 2013), reflecting lower provision expenses, and profit growth of subsidiaries and branches aboard. Investment companies (ICs) combined were profitable in 2014, but one-third of the companies recorded losses. The banking system's exposure to ICs diminished to 2.8 percent of banks' total lending, amid ICs ongoing downsizing of balance sheets.

4. Lower oil prices caused the fiscal position to deteriorate sharply in 2014/15. In the government's presentation, after mandatory transfers to the Future Generations Fund (FGF) of 25 percent of total revenues, and excluding investment income, the fiscal balance declined to a deficit of 4.4 percent of GDP in 2014/15 from a surplus of 11.7 percent in 2013/14.

Under the IMF presentation, which does not take into account transfers to the FGF and includes IMF staff estimate of investment income, the overall fiscal balance also narrowed sharply to a surplus of only 17.3 percent, compared to a surplus of 34.7 percent in 2013/14. The government increased diesel and kerosene prices and reduced subsidies on aviation fuel effective January 2015, with estimated savings of 0.3 percent of GDP annually, reduced medical allowances of Kuwaitis and relatives travelling abroad for treatment, as well as travel and other allowances of government employees. The current account surplus fell to 31.2 percent of GDP in 2014 from 39.5 percent in 2013.

II. Macro-financial Outlook and Risks

5. Investment in infrastructure projects will support non-oil growth in the medium term. High government buffers, a strong and liquid banking system, and a profitable corporate sector, provide the enabling environment for growth. A number of contracts have been awarded since 2014 in the oil sector to upgrade fuel and to increase the refining capacity that would have positive spillovers on domestic economic and financial activity. Non-oil GDP growth is projected to remain slightly lower in 2015-16 and thereafter increase to 4 percent over the medium term as the impact of large investments in 2015 takes effect. Average oil production declined in 2015 and is projected to increase by 2 percent a year in the medium term, consistent with the planned new investment to increase crude capacity. Overall, GDP growth will recover from 0.3 percent in 2015 to about 2.8 percent over the medium term. Average inflation is projected to increase to 3.4 percent in 2015 and will remain broadly stable at that level over the medium term, given limited global inflation.

6. The mission's view is that the peg to a basket remains appropriate for the Kuwaiti economy, as it continues to provide a nominal anchor. The authorities are fully committed to the current exchange rate regime. As of July 2015, the Kuwaiti dinar depreciated against the U.S. dollar by about 6.8 percent (y-o-y), whereas the nominal effective exchange rate appreciated by 3.1 percent during the same period. Staff's external assessment suggests a current account gap of 11 percent of GDP, which could be closed by increasing fiscal savings over the medium term. In the future, as the economy diversifies, more flexibility in the exchange rate might become appropriate.

7. The credit outlook for the banking system is supportive of growth given ample liquidity. Kuwait's credit cycle shows that credit growth is currently at its trend trajectory, mitigating concerns of a build-up of financial risks from excessive credit expansion. Continued efforts to develop money and debt markets would further strengthen liquidity management and improve monetary transmission.

8. Early formulation of a comprehensive long-term fiscal adjustment strategy is necessary. The government's fiscal balance (according to government presentation) is projected to remain in deficit over the medium term. After transferring revenues to the FGF, the central government fiscal deficit would remain in double digits as a share of GDP over the medium term, implying a cumulative deficit of KD23 billion between 2015-20. The government's high financial buffers and ample borrowing space will enable it to comfortably finance the short-fall. Nevertheless, to maintain confidence in the economy, preserve buffers, and reduce fiscal risks, fiscal adjustment plans should be expeditiously formulated and communicated, and the adjustment initiated. Total fiscal adjustment of about 12 percent of GDP will be needed over the longer term to achieve a fiscal balance that is in line with intergenerational equity and would also be sufficient to close the estimated external current account gap.

9. The choice of fiscal financing should weigh the pros and cons of various options to determine the optimal mix. Drawdown from the General Reserve Fund (GRF), as was done in 2014/15, would be consistent with the GRF's role as the Treasurer as well as the stabilization fund. There may also be merit in issuing domestic debt, which could help catalyze the development of a liquid local-currency debt market. However, any issuance of domestic debt would need to consider the cost of debt relative to the expected risk and return on the general reserve fund, and more importantly, its impact on the central bank's foreign exchange reserves, and the capacity of the banking system to absorb government debt without crowding out private credit. Depending on the rating and terms of borrowing, issuing foreign currency debt abroad could constitute an additional option that would not affect central bank reserves.

10. Tighter global liquidity conditions would impact the Kuwaiti financial sector, government and households, with feedback effects on the real economy. While banks have significant direct and indirect exposures to real estate and equity markets, they have high capital and provisioning to withstand shocks, and the central bank is proactively monitoring and mitigating risks with macroprudential tools. The upward trend in wholesale funding, although low, and the geographical diversification of assets warrants enhanced monitoring to limit potential spillover risk from the region.

11. Stress tests conducted by the mission suggest continued overall banking sector resilience. A few banks, however, turn out to be more sensitive than others and could require additional capital under severe stress scenarios. Given the interlinkages in the financial system, abrupt changes in market conditions could pose a risk to the financial system and the economy during periods of stress. The balance sheets of nonfinancial corporations could also be affected, notwithstanding their comfortable levels of debt servicing capacity. Households would face adverse wealth effects from a decline in stock prices. ICs are facing valuation losses from their investments in the local equity market. There is further scope to better identify and mitigate spillovers through the financial sector, and to continue to build buffers of the banking system. Although the probability of realization of large shocks is low, this calls for strengthening resolution plans for banks, which is work-in-progress. Strengthening the macroprudential policy framework, and refining the early warning system and toolkit, would enable a more systematic assessment and prevention of systemic risk. In particular, focused attention on collation of real estate indicators is warranted to monitor property market risks.

III. Policy Challenges
A. Fiscal Consolidation and Expenditure Composition

12. Commencing phased fiscal consolidation without delay is needed to close the fiscal gap, reduce fiscal vulnerabilities and bring the fiscal stance closer to benchmark levels indicated by intergenerational equity considerations. Delays in adjustment would result in a worsening fiscal position that would require a larger adjustment in the future, especially if oil prices fall further. The mission underscores the importance of not only a gradual pace of adjustment, in view of Kuwait's large buffers and oil and gas reserves, but also for it to fall mainly on current spending to create space for maintaining high capital expenditure, which has a stronger impact on growth. Prioritizing capital expenditure through better appraisal of investment projects, by introducing a systematic ex-post evaluation of projects, and by effectively implementing the anti-corruption framework assumes importance.

13. The government should take advantage of current low global energy prices to strengthen efforts to reform domestic energy prices. A gradual phasing-out of energy subsidies (estimated at 7.2 percent of GDP in 2015), with a social safety net and other mitigating measures and a well-designed communication strategy to get the buy-in of the middle class, would generate substantial savings. In the longer-term, energy price reform is expected to benefit growth by increasing efficiency in the economy and creating space for higher public and private investment. One-off effects on inflation should be manageable. Productive activities more sensitive to energy costs, particularly the transport sector, would be able to adjust to higher energy prices more easily if the reform is gradual.

14. The mission is of the view that any proposal to reform wages should, among other things, cap annual salary increases at the inflation rate and contain expansion in the wage bill. The government is considering a reform to standardize the wage structure in the public sector and provide a framework to limit wage growth. The wage reform's aim to simplify the wage structure and improve the current system is welcome. To achieve these objectives, the reform needs to include clauses to limit explicitly public employment growth and arbitrary increases in wages. When designing the framework, the authorities should be mindful of the impact of such a rule on the formation of inflation expectations in the economy. Moreover, an escape clause to hold wage growth below inflation when macroeconomic circumstances warrant should be included.

15. Efforts to raise non-hydrocarbon revenue needs to commence. Introducing a business profit tax on the net profits of all companies operating in Kuwait and simplifying the current tax structure would potentially increase revenues by KD 500-KD 800 million (1.3 to 2.1 percent of GDP). Implementation of the value added tax (VAT), which is also being discussed at the GCC-level, could yield an additional 2-3 percent of non-oil GDP. With the GCC having recently approved a VAT framework, Kuwait should now move ahead expeditiously with its implementation.

16. The mission welcomes the government's decision to move to top-down budgeting beginning FY 2016/17 and to a medium-term budgeting framework starting in fiscal year 2017/18. These reforms, besides providing better oversight and discipline to the budget planning and execution processes, would also build momentum to strengthen capital investment planning and prioritization towards high-growth sectors. Besides, an overall Public Financial Management Committee, chaired by the Minister of Finance, has been established to guide and supervise public financial management reforms. A decision has also been made for a full roll-out and implementation of the Government Financial Management Information System during FY 2016/17.

B. Strengthening Financial Stability

17. The CBK has strengthened regulations to safeguard financial stability. Banks are under Basel III regulations for capital, including a framework for DSIBs, liquidity, and leverage. In the real estate sector, banks are subject to loan-to-value ratio since November 2013, to a segment of individuals who purchase or develop residential property, besides debt-service-to-income ratio (DSTI) that already existed.

18. Macroprudential tools can help mitigate potential risks posed by banks' high exposures to the real estate sector. Some weakening of real estate activity appears underway in the commercial and investment segments, but the residential real estate segment reportedly remains firm. The latter is regulated by DSTI and maximum loan limits. While investment and commercial real estate financing is less regulated, rules regarding the treatment of real estate collateral, which encouraged this type of lending are being phased out. However, it is important to ensure that macroprudential policy measures are reviewed constantly to ensure that they do not exacerbate any property price correction, while preempting the buildup of excessive risks related to real estate exposures. In addition, heightened supervisory vigilance needs to be maintained to ensure that real estate exposures are appropriately classified and adequately provisioned. The mission encourages the authorities to construct real estate indices and suggests that other indicators, such as both the average and distribution of LTV and DSTI ratios, be compiled to calibrate measures at different phases of the credit cycle.

19. Given ICs interconnectedness in the financial system, the mission underscores the need for close monitoring of their activities, strengthened regulatory oversight, and further consolidation to strengthen this sector. A formal macroprudential coordination mechanism encompassing nonbank financial institutions would facilitate more systematic identification of systemic risks. Key improvements would involve: (i) assigning a macroprudential policy mandate and a delineation of its powers; (ii) establishing a formal financial stability coordination committee headed by the central bank, comprised of all financial system regulators, including the capital markets authority, the insurance supervisor, and the Ministry of Finance; (iii) ensuring appropriate accountability mechanisms; and (iv) elevating to a legal requirement the exchange of information.

C. Labor Market Reform and Diversification

20. Creating the right incentives for nationals to take up jobs in the private sector is crucial. Current labor market structures need to have the right incentive framework to create a skilled domestic workforce and lead to a self-sustained expansion in employment of nationals in the private sector. Current policies to keep unemployment among nationals low through public employment, quotas and permanent wage subsidy programs in the private sector are neither effective nor sustainable in the long run. They need to be underpinned by educational and training reforms and labor policies to improve skills, pay and productivity in the private sector. Empirical analyses suggest the existence of complementarities between expatriate and national labor that underscore the importance of treading gradually in any efforts to cap expatriate labor.

21. The authorities recognize the challenges in diversifying the economy and the need to improve the business environment and governance indicators. Recent efforts include finalizing foreign investment and SMEs by-laws, and streamlining registration and licensing procedures for investors. The establishment of Kuwait Direct Investment Promotion Authority has resulted in additional FDI into Kuwait. International experience suggests that, in addition to creating an economic environment favorable for doing business, Kuwait needs to implement policies to encourage firms to expand domestic operations and develop export markets, enhance infrastructure, and support workers in acquiring the necessary skills and education.

22. The corporate sector in Kuwait appears well positioned to weather shocks, including from the recent fall in oil prices, with most sectors displaying comfortable levels of debt servicing capacity. Ex-post profitability (return on assets) has remained stable but at low levels, particularly when compared with other countries, including GCC peers. Companies appear undervalued; lower price to earnings ratios than in peer countries may point to weaker confidence in Kuwait's business environment that the authorities are seeking to improve. Further deepening of asset markets to provide companies alternative means of financing and investment, improving the investment climate in the economy, including by reducing costs of doing business in Kuwait, increasing privatization efforts, strengthening corporate governance, establishing bankruptcy procedures, and better data availability to investors, would contribute to better performance of the corporate sector.

The IMF team values the candid and comprehensive discussions with the Kuwaiti authorities, and would like to express its sincere gratitude to them for their close cooperation.