Policy Paper - 03

Local Economic Outlook

Financial and Economic Outlook
for the Kuwait Economy

2019

مركز الكويت للسياسات العامة
Kuwait Public Policy Center

General Secretariat of the Supreme Council for Planning and Development

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Authored by Tariq Al-Rifai for KPPC.

Contact Details:
Kuwait Public Policy Center
kppc@scpd.gov.kw
Tel: 22452359
The Kuwait Public Policy Center
General Secretariat of the Supreme Council for Planning and Development
State of Kuwait

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Executive Summary

Kuwait's economy has recovered from the 15-month recession that ended in April 2018. The country reported 1.6% growth in the GDP during the first quarter of 2018, compared to -2.5% in the fourth quarter of 2017. The price of oil has been the single largest factor impacting the economy. Lower oil prices in 2015 and 2016 are to blame for the weak performance over the past three years. However, after reaching a decade low in January 2016, the price of oil has sustained its rise to around USD 80/bbl through September 2018.

The weak performance of the economy from September 2015 to September 2018 can also be attributed to structural issues in Kuwait's economy. Some of the factors preventing the economy from reaching its full potential include: slow implementation of the government's prior development plans; under-investment in infrastructure; bureaucracy/red tape; rigid rules and regulations on businesses from the Ministry of Commerce and Industry; and parliamentary gridlock.

From 2013 to 2016, government revenues fell by 60%, whereas public spending fell by a modest 8.3%. This disparity mitigated the negative impact of falling oil prices on the local economy. The government budget, however, went into a deficit in 2016 and 2017. The negative effect of fluctuating oil prices has prompted the Kuwaiti government to propose a grand development plan; called 2035 Future Vision, the plan outlines a path for transforming the country into a Northern Gulf hub for commerce and financial services.

The current, five-year plan has identified five main objectives to achieve by 2020, which are:

1. Improve the standard of living for citizens and increase their share of the gross domestic product.
2. Increase the private sector's contribution to the national economy.

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The current, five-year plan has identified five main objectives to achieve by 2020, which are:

1. Improve the standard of living for citizens and increase their share of the gross domestic product.
2. Increase the private sector's contribution to the national economy.
3. Raise the standard of educational, health, and social services.
4. Accelerate housing development for Kuwaiti society.
5. Improve the capabilities of governmental administration.

To boost the private sector's role in the economy, the government plans to privatize certain sectors - including logistics, communications and oil. In addition, it intends on developing programs to support small- and medium-sized enterprises.

There are many challenges, however, to the government's ability to carry out these plans and achieve its targets, including: bureaucracy; lack of accountability; corruption; and delays in legislative frameworks. The government also has a poor track record of hitting its planned targets. Its First Development Plan (2010/2011 – 2013/2014) failed to diversify the economy or decrease the country's dependence on oil revenues. Indeed, the trends went the opposite way; the government's percentage of revenue from oil and its role in the economy both increased, and the economy did not diversify.

In its Development Plan 2015/2016 – 2019/2020, the government has set a target of increasing non-oil sector GDP from 41% in 2015 to 64% by 2020. It also aims to reduce the oil sector's contribution to the GDP from 59% in 2015 to 36% in 2020. As of 2017, however, non-oil sector GDP had only modestly increased from 41% in 2015 to 44% in 2017. Thus, non-oil sector GDP will need to grow by 45% over the next three years to achieve the target of 64% of GDP in 2020. This target is not likely to be achieved, as such a high growth rate has never been observed in Kuwait.

Another initiative of the Development Plan is to raise the standard of living for citizens. This looks to be very challenging. GDP per capita in Kuwait has been falling consistently for the past 10 years. In 2013, it fell to third place among Gulf Cooperation Council (GCC) countries from second place in 2009.

During the past decade, foreign direct investment (FDI) has been negligible, a problem the Development Plan aims to change. Improvements to the investment climate and negative perceptions foreign investors have about Kuwait have yet to be addressed.

Increasing tourism has been one of bright spots of the Development Plan. Tourist arrivals increased by almost 50% from 2008 to 2016. There were approximately 4.7 million tourist arrivals in Kuwait in 2008, which increased to 7.1 million in 2016. Revenues from tourism also increased from USD 660 million in 2008 to USD 831 million, or 36%.

Thus, we expect Development Plan 2015/2016 – 2019/2020 to miss its main economic goals while still achieving some of its objectives. Specifically, there has been some success in streamlining government processes and procedures, which will have the effect of strengthening the government's ability to hit the targets outlined in the next five-year plan. The biggest challenge remains weaning the economy from its dependence on oil. The degree of success in diversifying the economy will affect other parameters, including: improving living standards; providing new job opportunities for citizens; stimulating entrepreneurship; and attracting foreign investment.

In the economic forecast scenario that we present here, we assume the government will achieve only limited success in its current Development Plan. We also wanted to show the impact of maintaining government spending on development programs as planned during the next global recession. This was done to determine how well the national economy could withstand external recessionary forces. As we expected, the national economy avoided a recession and was able to maintain a low level of growth. If, however, oil revenues fall, the government would have to borrow heavily to maintain current spending levels. The government's debt-to-GDP level is low and can sustain higher borrowing over a medium-term of three to five years. This borrowing strategy would not significantly strain the economy because any downsides would be offset by gains in the national economy and the continuation of the objectives outlined in the Development Plan.

As part of the national economic forecast, we also looked at global economic trends that can impact the national economy and its financial sector. The four major trends are:

1. Aging economic cycle and slowing GDP growth
2. Shift away from fossil fuels
3. Rising interest rates
4. Global trade wars

With these trends in mind, we also noted several synergies across GCC regional development plans. These synergies can support the national Development Plan and help in achieving its stated objectives. The United Arab Emirates, Saudi Arabia, Bahrain and Oman all have development plans, most of which are more ambitious than Kuwait's plan. Upon reviewing these regional development plans, we found three sectors that Kuwait can build upon: transportation and logistics, religious tourism, and support for small to medium-sized enterprises (SMEs), which will directly support FDI into the country.

Although there are synergies between Kuwait and other GCC development plans, the regional plans may also pose risks to Kuwait's ability to achieve its targets;

Those risks include:

1. Duplication of infrastructure and excess capacity
2. Rising competitiveness
3. Geopolitics
4. Failure of plan targets in other countries

The plan envisions establishing Kuwait as a financial hub/center. While there are well-defined benefits of such a vision, Kuwait will be competing against five existing financial centers in the GCC: Abu Dhabi, Bahrain, Dubai, Qatar and Saudi Arabia. To date, officials from the Central Bank and relevant ministries have not been able to articulate how Kuwait would out-compete the centers already in existence. Without a clear vision and competitive advantage, a financial center in Kuwait will not achieve the desired level of success. This can already be seen among the existing centers in the region. In the last decade, Bahrain lost its place as the leading financial center in the region to Dubai. Bahrain lacked a clear vision and was unable to invest as much as Dubai did in the building of its financial center. Weak leadership and a lack of aggressiveness in attracting foreign financial institutions were also to blame. Since then, Abu Dhabi and Qatar have launched competing centers with limited success so far.

In addition, the financial sector in Kuwait is not prepared to compete at a financial-center level. There are prerequisites that the government and banking regulators need to implement first before setting sights on developing a financial center. These include:

1. Encouraging bank mergers to strengthen local banks.
2. Allowing financial instruments to develop. The local economy offers limited financial instruments from which banks can profit and compete.
3. Loosening regulation on raising capital, which is the main financing obstacle for SMEs.
4. Leveling the playing field by allowing current registered foreign banks to compete directly with local banks.

In our previous report, we discussed in detail the global economic risks that can negatively impact the national economy. All of the issues mentioned are present today and pose the same level of risk. In this report, however, we discuss four major risks specific to Kuwait's financial sector and offer suggestions for mitigating these risks;

1. Collapse of oil prices
2. Global trade wars
3. Emerging market crisis
4. Global financial crisis

Finally, we offer suggestions for managing the sovereign wealth fund and the financial services sector during a scenario of a prolonged downturn in oil prices.

Suggestions for managing the sovereign wealth fund:

- The goal of the sovereign wealth fund needs to be clarified. It is currently being managed as a pension fund with specific return targets instead of a wealth preservation fund. This forces the fund's managers to seek out riskier investments.
- Invest in higher-risk investments only if there is an associated benefit to the national economy, such as technology transfers.
- The fund should limit its involvement with higher-risk global banks, because the large global fund managers (non-banks) are safer.
- Increase the percentage of funds managed in-house, which will also develop national talent and expertise in this field.
- Develop a sustainable investment program having less correlation to oil prices, such as the growing demand in alternative energies.

Suggestions for reducing the impact on the financial sector:

- Encourage mergers of local banks to strengthen their financial standing.
- Develop a stronger understanding of their exposure to emerging markets and ensure that risks are properly hedged.
- Reduce exposure to high risk global financial institutions.
- Promote the development of new financial instruments that will benefit the local market, such as mortgages, securitization and launch an alternative capital market.
- As the price of oil falls, the government should issue local debt instruments in order to maintain current spending levels. It will also provide new investment instruments for the financial sector and support the development of a secondary market for trading such instruments.
- Allow existing foreign banks in the country to compete with local banks.

Introduction

Kuwait's national economy has been more resilient than that of its regional peers over the past three years. Regionally, economies suffered because the price of oil fell 75% from 2014 to 2016. As the price of oil recovered, GCC economies also recovered - albeit with differing results.

Since then, Kuwait and other GCC countries embarked on economic liberalization and modernization plans as a way to diversify away from their dependence on oil revenues. At the same time, these countries realized the need to offer their citizens new economic and educational opportunities, as well as a world-class health care system.

For Kuwait, in particular, a comprehensive economic development plan that articulates a clear vision and sets achievable milestones is long overdue. Nearly three decades of economic stagnation, slow development, mismanagement and political gridlock have left the country in dire need of a new path forward. To that end, Kuwait revamped its long-term development plan, the 2035 Future Vision Plan, making it the most comprehensive and ambitious plan in recent memory. Implementing the objectives, however, will be challenging, given that targets from an earlier plan, called First Development Plan, were not achieved. To more easily manage the meeting of long-range targets, the 2035 plan is subdivided into a series of incremental plans that are of one-year and five-years in length.

The plan to date has witnessed some success, particularly in e-government services. But focusing on internal factors alone will not be sufficient to drive continued progress. A variety of regional and global economic factors must be considered when implementing the national development plan. Though these factors cannot be controlled, they need to be better understood so that their effects on the national economy – both positive and negative - can more suitably be managed. In particular, policymakers should look at the potential for achieving synergies with other regional development plans as a way to achieve mutual targets. They also should consider how both higher and lower oil prices and regional and global risks may impact these plans. The financial services sector is especially sensitive to these risks.

Policymakers should be prepared to address various economic scenarios in order to mitigate risks to the national economy and to achieve the stated targets in the Development Plan. This includes developing a separate document outlining scenarios and economic views that differ from the mainstream views of leading international agencies, such as the World Bank and International Monetary Fund (IMF). Plans that would mitigate and protect the country's sovereign wealth under these alternative scenarios also need to be created.

I. Financial and economic outlook on Kuwait

All of Kuwait's key macroeconomic indicators have shown noticeable improvement over the past year. Sustained higher oil prices have improved government finances as well as local economic performance. However, lower oil prices over the past three years compared with much higher oil prices over the prior three years affected all sectors of the Kuwaiti economy to varying degrees. In other words, the recovery has been inconsistent across economic sectors.

Lower government revenues in recent years have focused a spotlight on the government's need to push ahead with a comprehensive economic reform plan; its goal is to diversify the economy and move away from a dependency on volatile revenue from oil. The government's 2035 Future Vision plan aims to transform Kuwait's economy and, as a consequence, its society over the next 17 years.

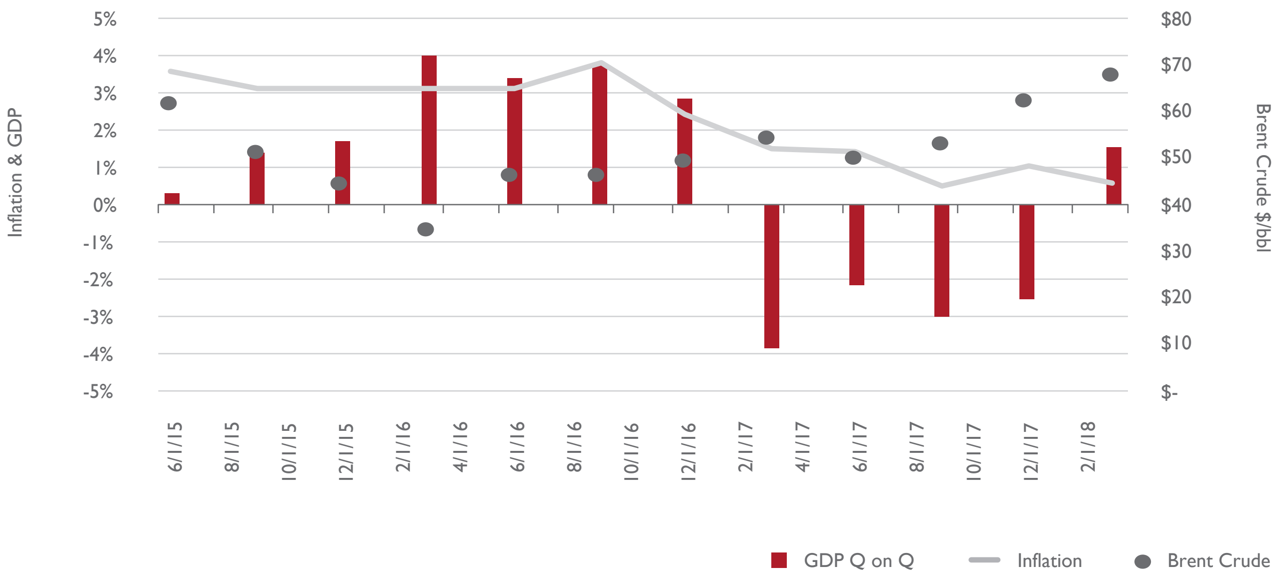
How will this long-term development plan affect the economic performance of the local economy? What are external factors that can impact the set targets of the development plan? And, where do we expect the Kuwaiti economy to be in the next five years? Answers to these questions will be addressed in this section.

a. Snapshot of recent economic performance

Kuwait's economy registered positive GDP growth in the first quarter of 2018 (Q1) after being in recession for all of 2017. GDP in Q1 2018 was 1.6% compared to -2.5% in Q4 2017. The relative stability of the Kuwaiti dinar versus the US dollar helped put downward pressure on local inflation. Over the past three years, inflation has gone from 3.6% in Q2 2015 to 0.6% in Q1 2018.

FIGURE 1

Quarter on quarter GDP growth rate compared to the local inflation rate and the average price of Brent Crude oil during the respective quarter

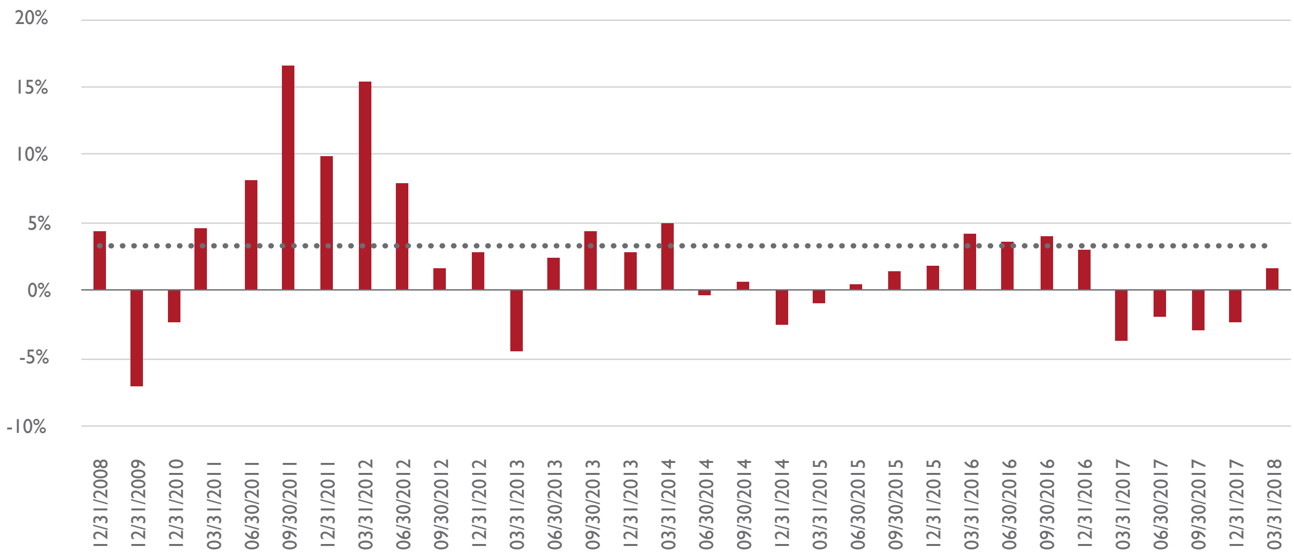


Source: Kuwait Central Statistical Bureau, Trading Economics and Thomson Reuters.

The most significant factor impacting the economy has been the price of oil. Lower oil prices in 2015 and 2016 are to blame for the weak performance over the past three years. However, after reaching a decade low of USD 26/bbl in January 2016, the price of oil has had a sustained rise to September 2018. It is important to note that from September 2018 to the end of 2018, the price of oil fell more than 25%. The average price of Brent Crude during the second quarter of this year (Q2) was USD 74/bbl.

FIGURE 2

Change in GDP over the last 10 years compared to the average GDP growth rate since 1994 (dotted line)



Source: Kuwait Central Statistical Bureau and Trading Economics.

From a long-term perspective, the Kuwaiti economy has been performing below its 23-year average of 3.4% annual GDP growth (average GDP growth from 1994 to 2017) as can be seen in Figure 2. It is worth noting that the recession in 2009 was shorter (yet more severe) than the recession in 2017. This is attributed to the quicker recovery of oil prices in 2009 than in 2016.

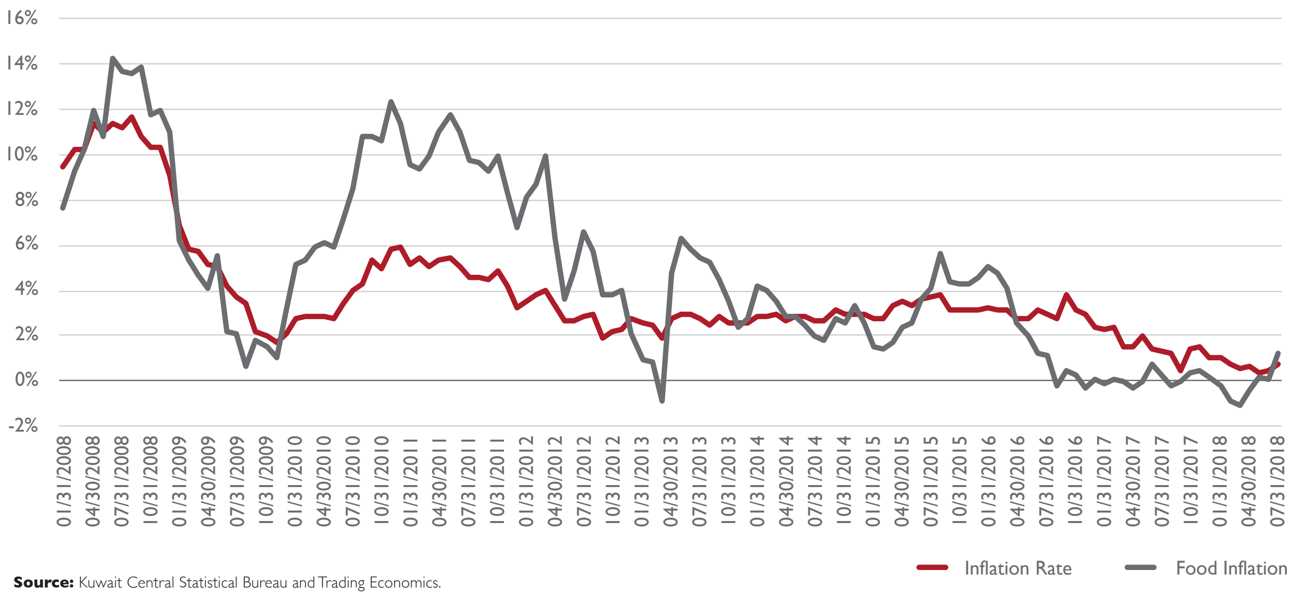
Longer-term underperformance can be only partially blamed on the volatility of oil prices. The primary reason for this underperformance is due to structural issues in Kuwait's economy. Also to blame is the slow implementation of prior development plans, under-investment in infrastructure, excessive bureaucracy/red-tape, rigid rules and regulations, and parliamentary gridlock.

At this point, higher oil prices can only sustain economic growth to a certain and moderate level. To reach higher economic growth targets above the 23-year average, the government will need to successfully execute 2035 Future Vision.

Lower inflation also has contributed to the improving macroeconomic landscape. Figure 3 depicts Kuwait's steadily declining inflation over the past 10 years. In 2010 and 2011, rising food inflation, in particular, was a key factor propelling the increasing social unrest in the Middle East and North Africa (MENA) region, which is widely believed to have helped spark the Arab Spring. The double-digit food inflation figures witnessed in Kuwait in 2010 and 2011 have dropped to 1% as of the first quarter of 2018, a figure that had not been seen since 2014. Overall inflation dropped from a decade high of 4% in 2016 to 0.6% as of Q1 2018.

FIGURE 3

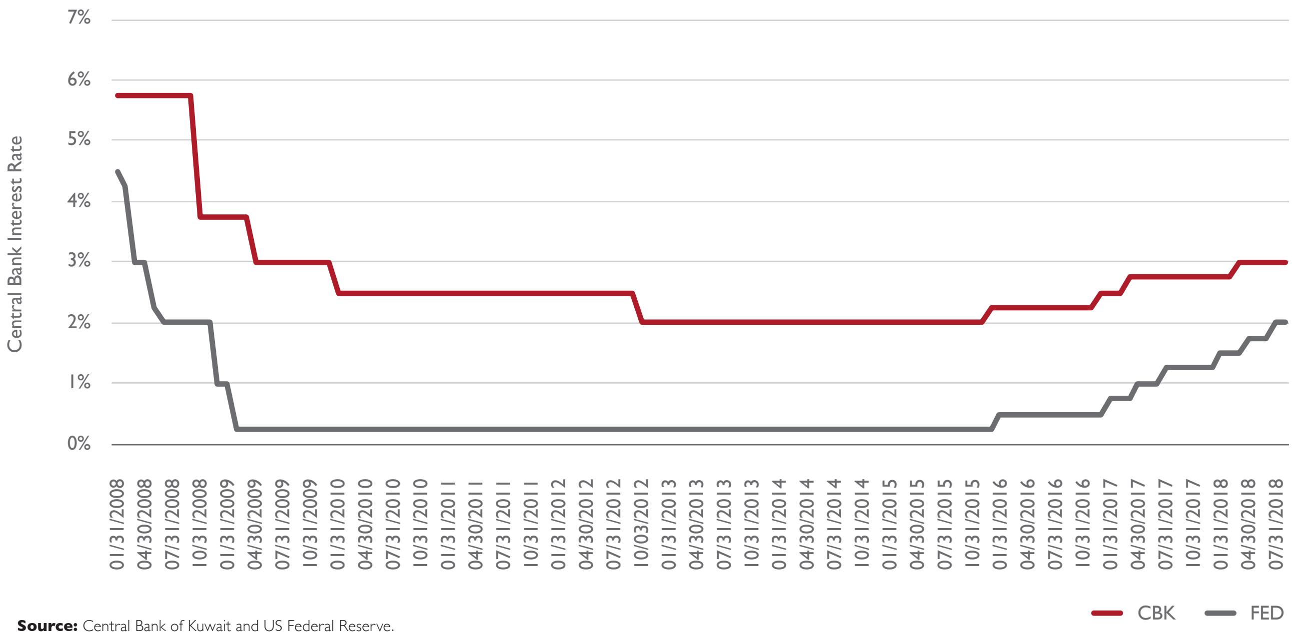
Overall inflation rate in Kuwait since 2008 compared to food inflation rate



Source: Kuwait Central Statistical Bureau and Trading Economics.

FIGURE 4

Change in Kuwait Central Bank benchmark interest rate compared to US Fed Funds rate

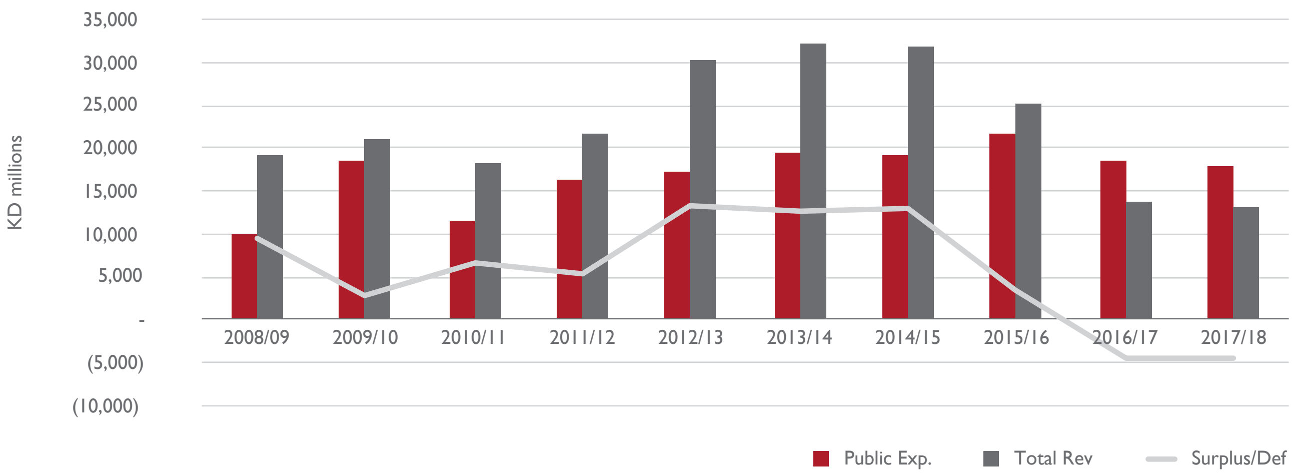


Source: Central Bank of Kuwait and US Federal Reserve.

The stability of the Kuwaiti dinar against the US dollar is reflected in the central bank's interest rate policy. Figure 4 shows the parallel rise in the Central Bank of Kuwait (CBK) benchmark interest rate and the US Federal Reserve interest rates, beginning in December 2015. This parallel policy is necessary to manage the dinar's peg to a currency basket, which is heavily weighted towards the dollar. The successful management of the currency by the CBK has helped keep inflation figures low.

FIGURE 5

Total government revenues and expenditures over the last 10 budget years



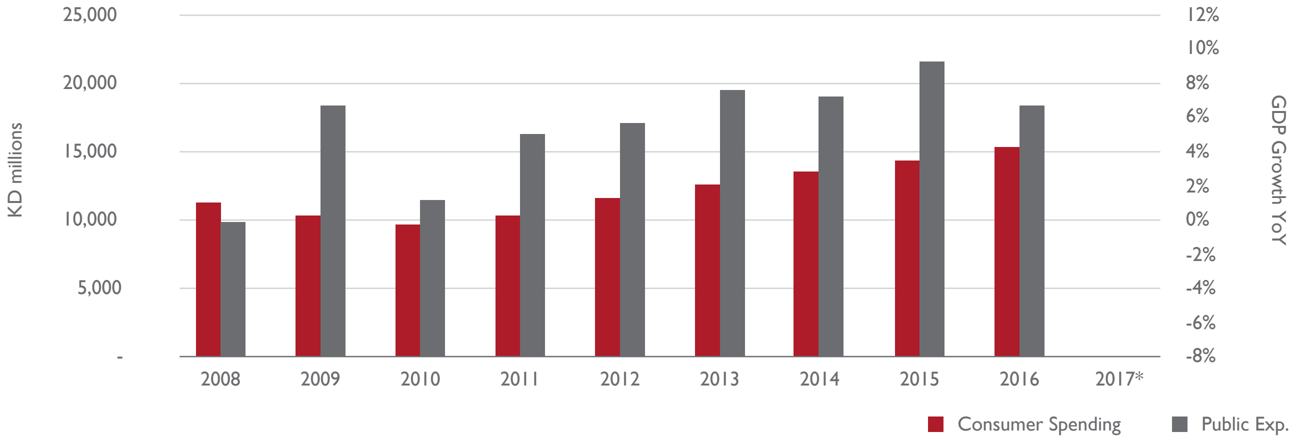
Source: Central Bank of Kuwait.

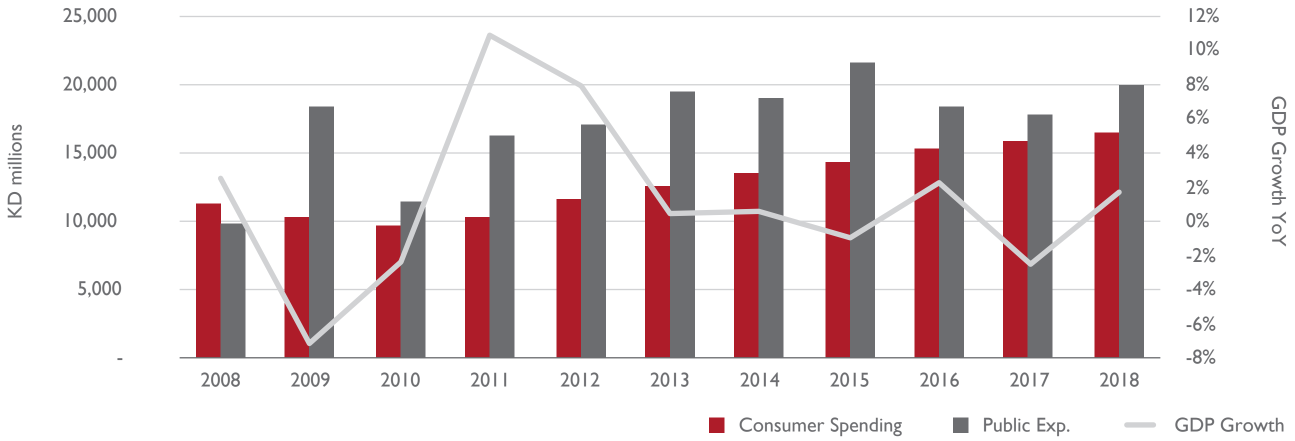
Government revenues are growing again, thanks to rising oil prices. This year, total government revenues (oil and non-oil) are expected to rise for the first time since 2013. Total government revenues fell by 4% from 2016 to 2017, while government spending over that same period dropped 3%. Total government revenues rose to a record high of KD 32 billion in 2013. By 2017, however, total government revenues fell by 60% from 2013 to reach KD 13 billion, as can be seen in Figure 5.

In 2016 and 2017, the Kuwaiti government budget was in a deficit. However, it is important to note that during the period 2010/2011-2013/2014 where government revenues were rapidly rising, public spending rose only modestly. Thus, when government revenue fell by 60% from 2013 to 2017, public spending fell by only 8.3%. This disparity helped lessen the negative impact on the local economy as oil prices fell.

FIGURE 6

Public spending and consumer spending compared with year-on-year GDP growth rate. 2018 consumer spending is estimated



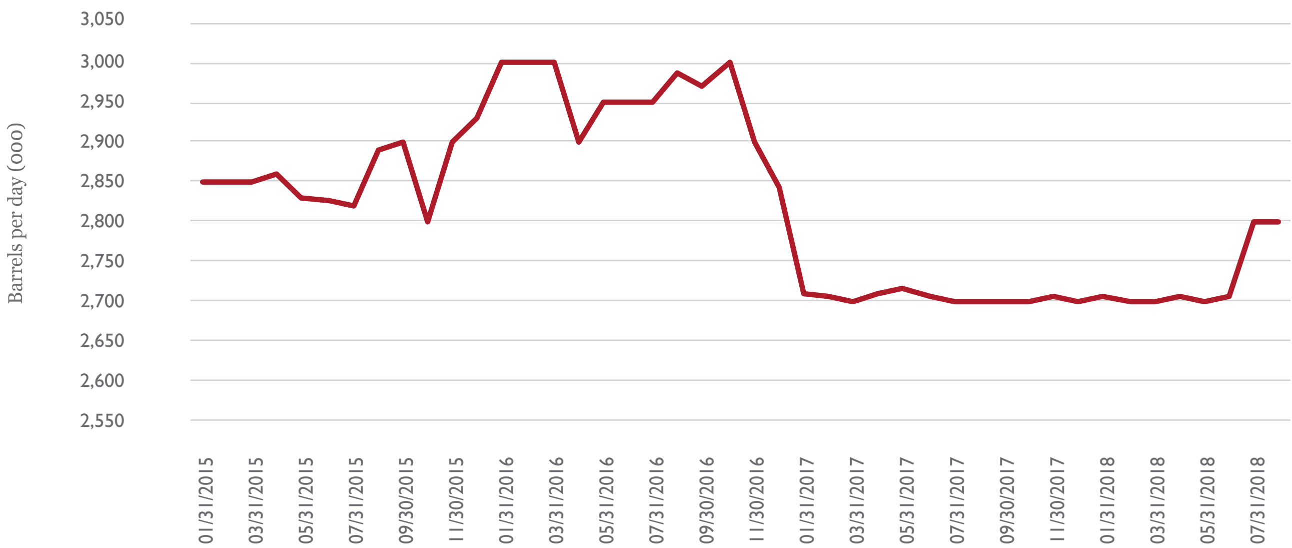


Source: Kuwait Ministry of Finance, Central Statistics Bureau, Trading Economics.

Another factor that has helped sustain the economy is the steady rise in consumer spending, as can be seen in Figure 6. Falling oil prices had no impact on consumer spending. In fact, it has been steadily rising since 2010. The negative impact on the local economy brought about by lower government spending was offset, to a large degree, by the private sector.

FIGURE 7

Kuwait's average daily crude oil production by month average



Source: OPEC and Trading Economics.

Kuwait's daily oil production quota, per the OPEC agreement signed in December 2016, was reduced by 10% from 3 million barrels per day to 2.7 million barrels per day throughout 2017 and the first half of 2018. As of July 2018, Kuwait has been producing an average of 2.8 million barrels per day. The reduced quota along with lower oil prices together amplified the drop in overall revenues that the government received during this 18-month period.

b. National development plan and its expected impact on the economy

In January 2015, the State of Kuwait kick-started its five-year, medium-term development plan. The 2015/2016 – 2019/2020 Development Plan is an incremental stage in the long-term plan known as 2035 Future Vision. Each five-year plan is further subdivided into annual plans in order to monitor the progress and implementation of the set objectives and programs. The 2017/2018 Development Plan is the current annual plan.

The structure of the plan is based on seven core pillars. These seven pillars are:

1. Effective Government Administration;
2. Sustainable Diversified Economy;
3. Advanced Infrastructure;
4. Sustainable Living Environment;
5. High Quality Healthcare;
6. Creative Human Capital;
7. Outstanding International Status.

TABLE 1

The seven pillars of the country's comprehensive development plan

1	2	3	4	5	6	7
Effective Government Administration	**Sustainable Diversified Economy**	**Advanced Infrastructure**	**Sustainable Living Environment**	**High Quality Healthcare**	**Creative Human Capital**	**Outstanding International Status**
• E-government program • Structural plan reform program	• Business environment preparation program for the private sector • Diversification of the production base and increasing investment rate • National tourism development program • State financial and economic reform program • Knowledge economic program	• Air transport system development program • Land transport system development program • Sea transport system development program • Information and communication technology infrastructure program	• Program to expedite the provision of housing care to the citizens • Renewable energies employment program • Air environment safety conservation program • Waste management capacity enhancement program	• Health services quality program • Reduction of non- contagious chronic diseases program • Increasing public hospital bed capacity program	• Education quality program • High education capacity increase program • Labor market unbalance reform program • Traffic safety program • Handicapped welfare and integration program • Elderly care services standard enhancement program • Social cohesions enhancement program • Youth welfare and enablement program	• Program of promoting the State of Kuwait image on the international scale • Program for supporting culture, art, information and development

Source: State of Kuwait Annual Development Plan 2017/2018.

Within each pillar is a set of specific development programs - 29 programs in total - as shown in Table 1. These programs have been selected for their ability to improve the status of Kuwait's global competitiveness. This plan is designed to help the country reclaim its status as a regional financial and commercial hub with the private sector taking on a leading role in economic activity.

As such, the current five-year plan has identified five main objectives to achieve by 2020:

1. Improve the standard of living for individuals and increase their share in the Gross Domestic Product;
2. Increase private sector contribution to the national economy;
3. Raise the standard of educational, health, and social services;
4. Accelerate housing development;
5. Improve the capabilities of governmental administration.

This report focuses on the financial and economic aspects of the plan. Specific attention was given to reviewing the effectiveness of the plan in boosting the role of the private sector in the economy and in liberalizing regulations. When examining how the government intends to achieve its objectives in these areas, we found heavy emphasis on privatization and the promotion of entrepreneurship. The following are highlights from the plan:

- Privatize the current stock market, create specialized stock markets, and establish multiple clearing companies to spur competition.
- Kick-start the role of the Supreme Council for Privatization, and grant it wide-reaching authority to carry out its work.
- Work on privatizing the following sectors:
    - Logistics: Privatize the Border Authority, Ports Authority, and services for customs, clearing, and laboratories, via a group of competitive joint-stock companies.
    - Communications: Launch the Communication and Information Technology Regulatory Authority. Expand the role of the private sector in providing communication services, including Internet access.
    - Oil and Gas: Allow the private sector to invest in any and all domains, including transportation, distribution, and filtration of crude oil, gas, and derivatives, as well as in related industries.
- Provide support for small and medium-sized enterprises, including small entrepreneurs, and increase Kuwaiti workers' presence in the private sector.

These economic development plans are ambitious and come with many challenges, much of which have to do with the government itself, which was noted in the current five-year plan. These challenges include, but are not limited, to:

- Bureaucracy, over-regulation, overlapping ministry jurisdictions and inefficient government procedures have led to a rise in the direct and indirect costs of starting and running businesses;
- Absence of accountability and a lack of objective evaluation of government leadership;
- Government corruption has damaged the credibility of the investment and business environment;

- Planned legislative frameworks supporting economic and social development have been routinely delayed, this includes amended legislation on privatization;
- There is no clear vision on Kuwait's role in developing the country into a regional commercial corridor in the northern Gulf in a way that reinforces its role as a commercial hub;
- Weak participation in the economy from non-oil sectors, especially the financial and commercial services sectors;
- Slow implementation of the privatization of large projects, as well as public joint-stock companies and build-operate transfer (BOT) projects;
- Limited privatization to date of government services along with an unclear plan for more quickly moving privatization forward;
- Unsustainable government finances. Most significantly, the rise in wages, salaries, social benefits and various forms of aid;
- Government and private sector investment spending has remained below target levels, negatively affecting the ability to push through new investments;
- Limited incentives for attracting investment to Kuwait coupled with the inability to meet global standards for infrastructure have led to a weak manufacturing sector.

The above are just the highlights of the main challenges outlined in the plan. The success of the five-year plan and, indeed, the 2035 Future Vision Plan itself depends upon overcoming these challenges. The government is overwhelmingly the main obstacle to success. This is why much effort has been put into the government's structural reform plan that, once complete, should resolve several key issues.

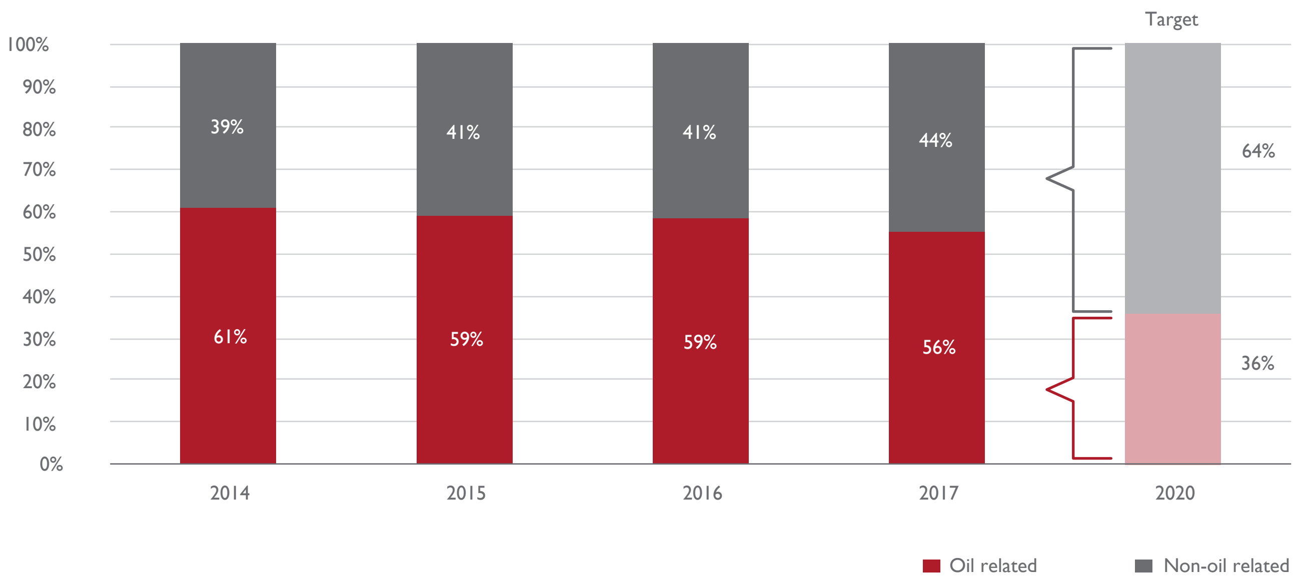
It is important to note that the government's First Development Plan (2010/2011 – 2013/2014) was not successful due to the issues outlined above. The following are some of the main objectives of the plan and their respective outcomes at the end of the fourth year:

- Little economic diversification occurred, so the economy could not move away from its dependence on oil. The oil sector's contribution to GDP was expected to slowly rise from 34.2% in 2010 to 39% in 2014. Instead, the increase was much faster, hitting a startling 56.1% in 2014. Rapidly rising oil prices during this period were partly to blame. But so, too, was the government's failure to invest in other sectors and jump-start the privatization program.
- The target for the non-oil sector's share of the GDP was 61% by 2014 from 65.8% in 2011. In 2014, actual non-oil sector contribution to the GDP plummeted to 43.9%.
- The government had an ambitious plan to reform the state's public finance structure by raising non-oil public revenue to 30% of total revenues. In reality, the percentage did not exceed 6.7% for the plan's four-year average. Reasons for this cited in the State of Kuwait Annual Development Plan 2017/2018 include an absence of new tax laws and a failure to amend the decree on fees for and utilization of public services. The failure to start privatization also caused state finances to lose out on revenues from asset sales to investors and revenues from granting franchising or utilization rights.
- Current spending increased from 73% of total public spending in 2011 to 89.9% in 2014, while investment spending dropped from 33% of its planned spending level to an average of 10.1% over the four-year period. This low-investment spending resulted from administrative and institutional obstacles that affected the launch and implementation of projects.

Past experience, new leadership and a renewed push from the top levels of government have put pressure on the reform plan's progress. While the current government might succeed in its structural reform plans, which are an indispensable element for achieving the 2035 Future Vision Plan, it is highly likely that the government will, again, fall short of its economic targets.

FIGURE 8

GDP related from oil sector compared to public and private sector non-oil related GDP highlighting set target per 5-year Development Plan

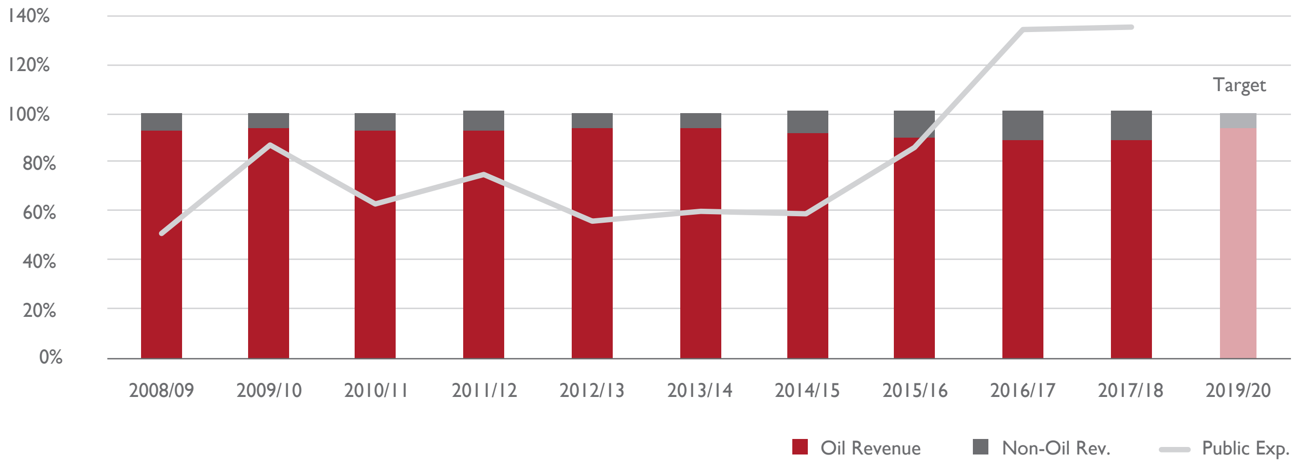


Source: Central Bank of Kuwait and State of Kuwait Draft Development Plan 2015/2016 – 2019/2020.

In its Development Plan 2015/2016 – 2019/2020, the government set a target of increasing non-oil sector GDP from 41% in 2015 to 64% by 2020 (Figure 8). This, in turn, means lowering oil sector GDP from 59% in 2015 to 36% by 2020. As of 2017, non-oil sector GDP has only modestly increased from 41% in 2015 to 44% in 2017. In other words, non-oil sector GDP will need to grow by 45% over the next three years to achieve the target of 64% of GDP in 2020. Barring a collapse in the price of oil, achieving this target seems very unlikely.

FIGURE 9

Kuwaiti government oil revenues compared to non-oil revenues and total public spending as a percentage of total revenues

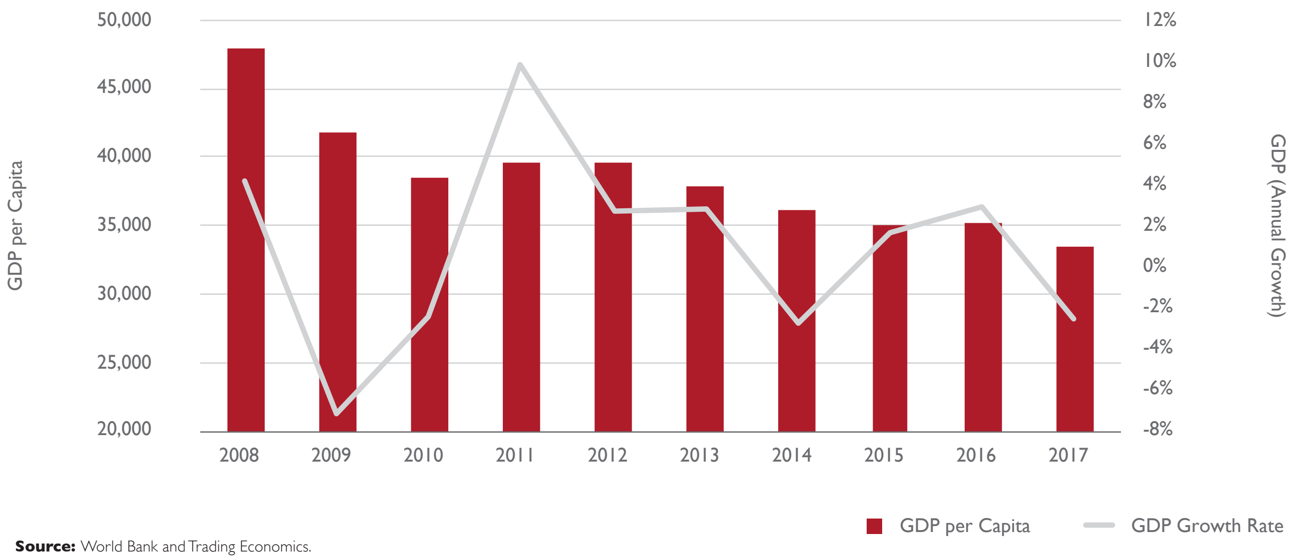


Source: Central Bank of Kuwait and State of Kuwait Draft Development Plan 2015/2016 – 2019/2020.

The target for non-oil related government revenues has been achieved early. The plan calls for 6.5% of government revenues to come from non-oil related activities by 2020 (Figure 9). As of 2017, 12% of revenues were from non-oil related activities. The reason for this modest target is most likely because the government has established a longer timeline to reform the tax system and establish new taxes as well as a slow the rollout of the privatization program.

FIGURE 10

Change in GDP per capita compared to GDP growth rate

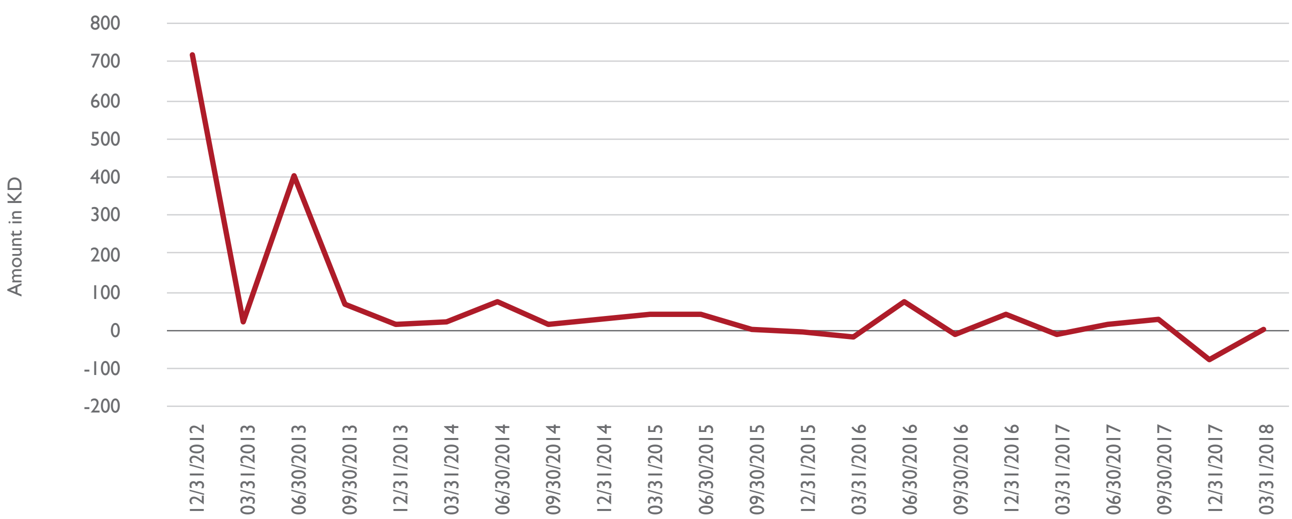


Source: World Bank and Trading Economics.

Another initiative of the Development Plan is to raise the standard of living for citizens. This, however, is proving to be very challenging. As Figure 10 shows, GDP per capita in Kuwait has been falling fairly consistently for the past 10 years. It has fallen to third place among GCC countries from second place in 2009.

FIGURE 11

Foreign direct investment coming into the country

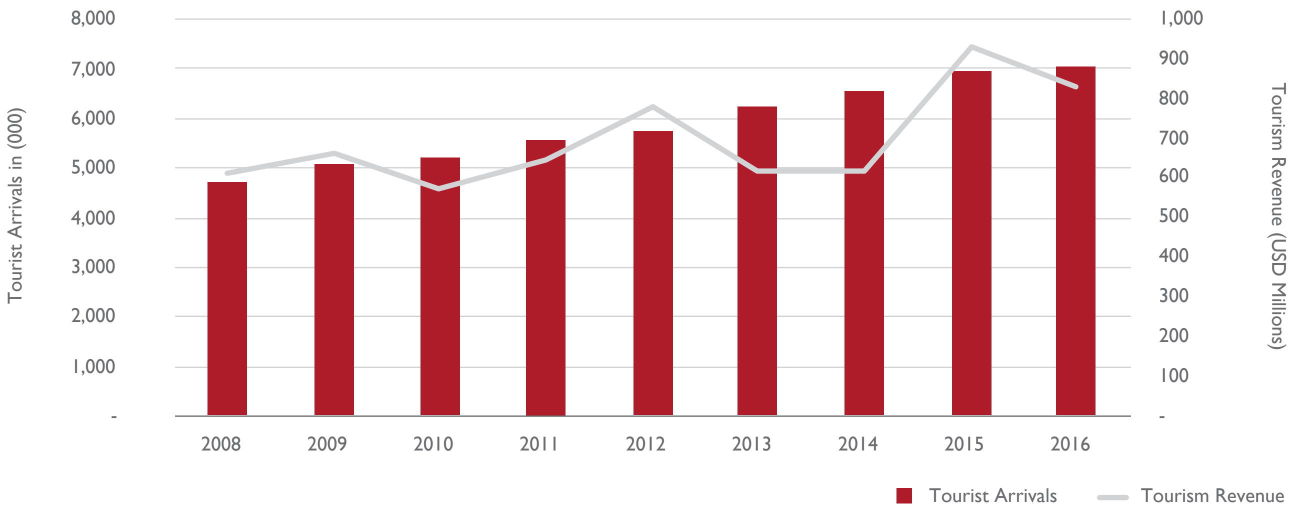


Source: Central Bank of Kuwait.

Foreign direct investment (FDI) has been almost non-existent in the country (Figure 11). There were some successful investments in 2012 and 2013, but since then, the degree of FDI has been negligible. Improvements to the investment climate and negative perceptions foreign investors have about Kuwait have yet to be addressed.

FIGURE 12

Tourist arrivals and tourism revenue



Source: The Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRIC) and Trading Economics.

One 2035 Future Vision initiative that has had some success is boosting tourism. Tourist arrivals increased by almost 50% between 2008 and 2016 (Figure 12). In 2008, Kuwait saw approximately 4.7 million tourist arrivals. By 2016, this figure had risen to 7.1 million. Kuwait also saw revenues from tourism rise by 36%, from USD 660 million in 2008 to USD 831 million.

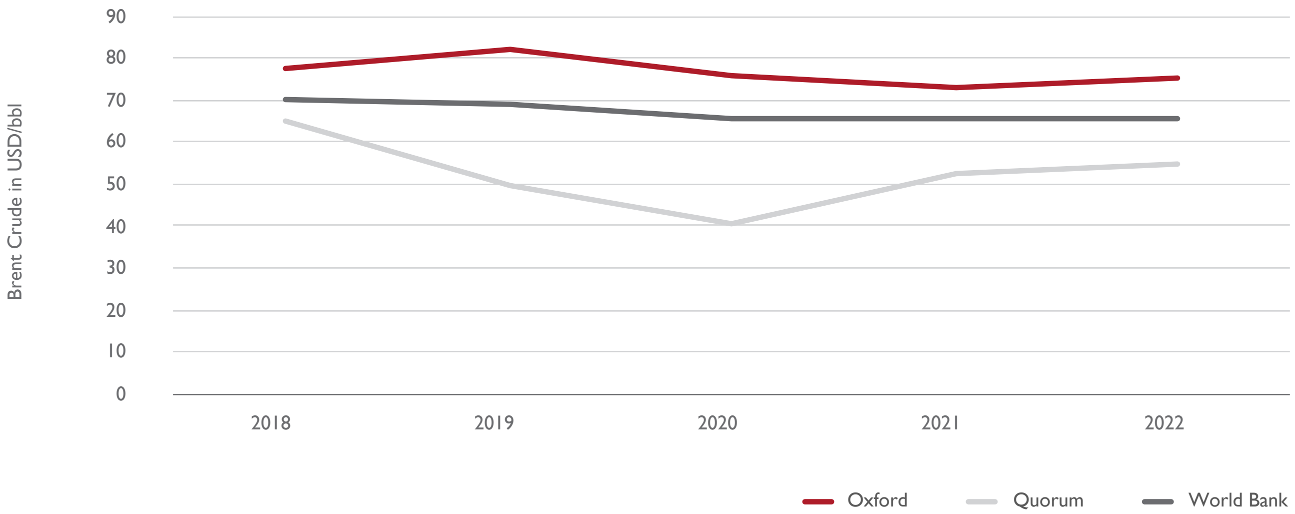
Therefore, we expect Development Plan 2015/2016 – 2019/2020 to achieve some success while missing its main economic targets. The government has streamlined processes and procedures; that, in turn, will strengthen its ability to meet the targets set in the next five-year plan. The biggest challenge, however, will remain the difficulty in diversifying the economy away from its dependence on oil. This, as a result, will also impact other targets, including increasing the standard of living, providing new job opportunities for citizens, stimulating entrepreneurship and attracting foreign investment.

c. Forecast for the national economy over the next five years ore pillars.

When considering our five-year economic forecast for Kuwait, we looked at two existing scenarios – the World Bank and the Oxford Economics Baseline. Based on these scenari-os and our own assumptions about the global and national economies, we developed our scenario for Kuwait (Quorum Scenario). Since neither the Oxford Economics nor World Bank scenario forecast a global recession or financial crisis, we assumed a normal global recession in our scenario. In addition, we assumed lower oil prices would be sustained throughout the next five-year period (Figure 13).

FIGURE 13

Scenarios for Brent Crude price

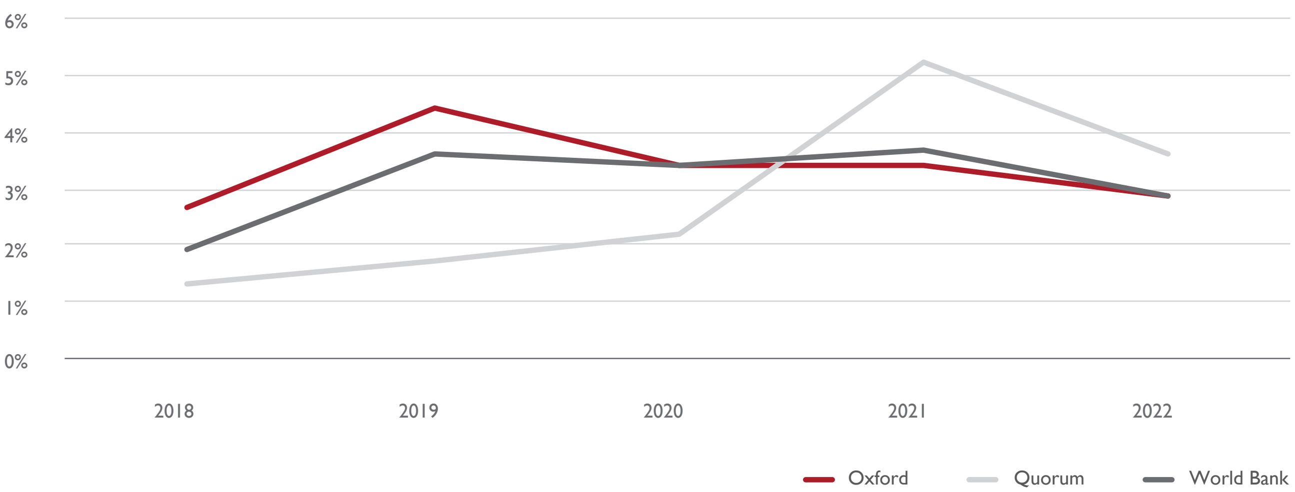


Source: World Bank and Oxford Economics.

In our scenario, we wanted to show the impact of maintaining government spending, as planned, on development programs during a global recession. The main purpose in doing this was to see how the national economy would withstand external recessionary forces.

FIGURE 14

Scenarios for GDP growth

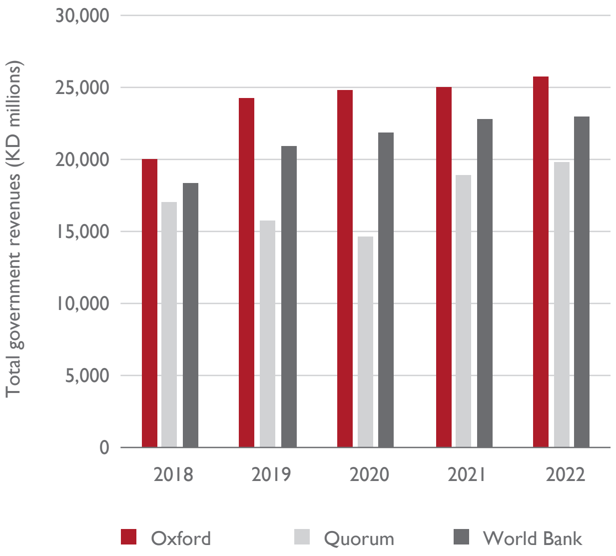


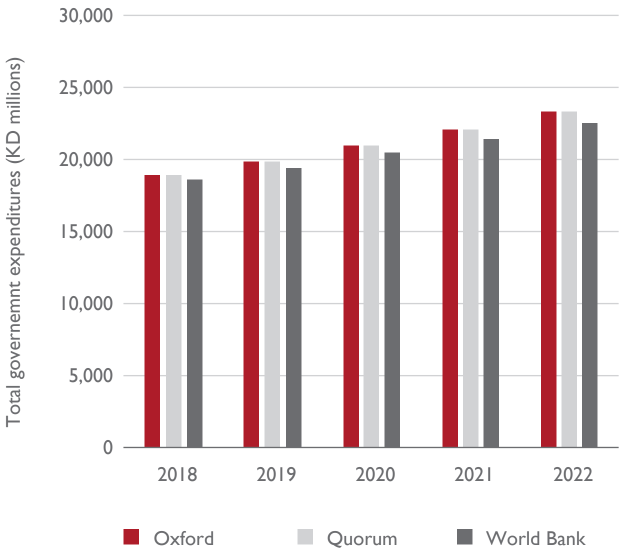
Source: World Bank and Oxford Economics.

As can be seen in Figure 14, our scenario shows a marked slowdown in the national economy, but one that does not lead to a recession. This is due to sustained government spending throughout this period. In other words, even with a global recession and a sharp decline in oil prices, Kuwait's economy would be able to avoid a severe recession.

FIGURE 15

Scenarios for total government revenues and expenditures



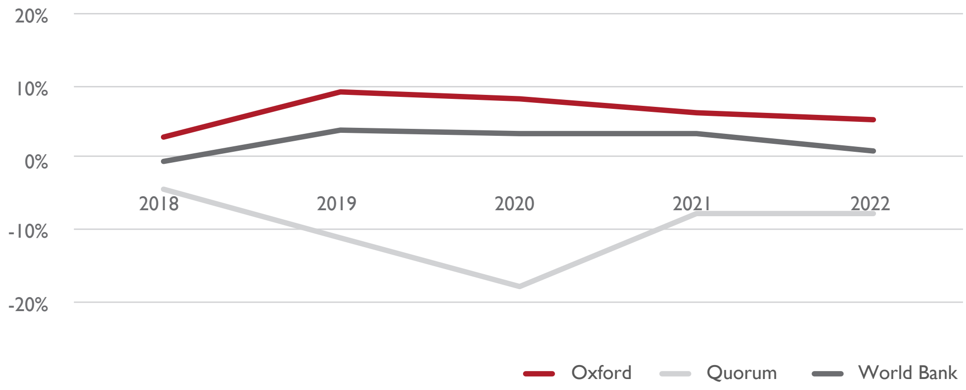


Source: World Bank and Oxford Economics.

Government revenues decline sharply in our scenario compared with the baseline scenario of Oxford Economics and the forecast of the World Bank. However, government spending levels would be maintained at the same level as the other scenarios, as can be seen in Figure 15.

FIGURE 16

Scenarios for government budget surplus/(deficit)



Source: World Bank and Oxford Economics.

On the flipside, to be able to maintain current budgeted spending levels, the government would need to borrow heavily. Borrowing on such a scale would require tapping international markets, as the local financial institutions would not be able to absorb the demand. The government is currently in a healthy position to borrow at these levels and at favorable rates. Any downside risk to this medium-term borrowing plan would be offset by gains in the national economy and the continuation of the objectives outlined in the development plan. Details of these three scenarios can be found in Appendix B.

II. Implications of globalization and regional development plans on the national economy

Several external factors directly impact the national economy, the price of oil being the most significant. Government revenues are highly sensitive to the price volatility of this commodity. This, in turn, impacts the national economy.

But other factors can also impact the national economy. Some of these are regional while others are global. Below are some of the main global and regional trends that we feel can impact the national economy over the next few years.

a. Global economic trends and their potential impact on the national economy

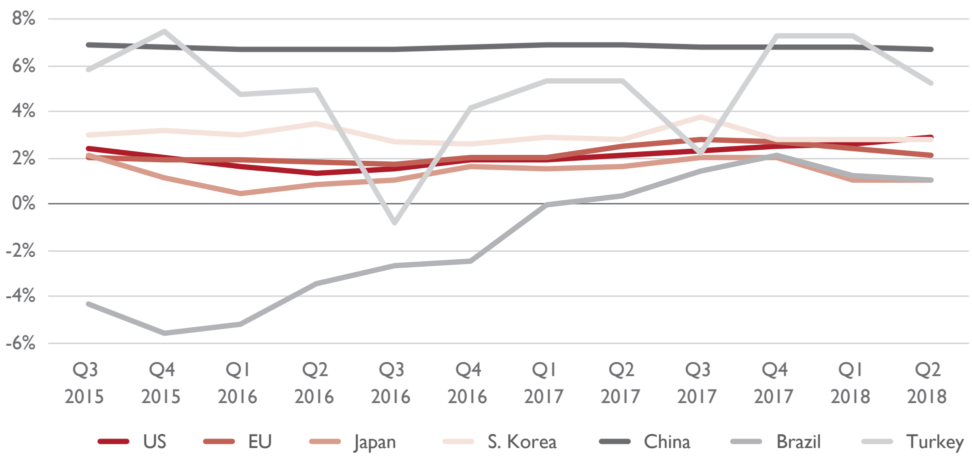
There are four global trends that can impact the national economy: the aging economic cycle; the shift away from fossil fuels; rising interest rates; and a global trade war. These four trends are described below.

1. Aging economic cycle and slowing GDP growth

We discussed economic cycles in detail in our previous report, The Global Economic Outlook in the Context of the Global Financial Services Sector (30 June 2018). We believe that the current economic growth cycle, which has lasted longer than all previous economic cycles, is mature, and that the most likely scenario over the next year or two is that this cycle changes from a growth cycle to a contractionary cycle (recession).

FIGURE 17

GDP growth rates in advanced economies compared with emerging economies and the world



There are already signs of widespread economic slowdown around the world, with the exception of the US - which has seen a sustained rise in economic growth. Outside of the US, GDP growth in the three largest economies - the EU, China and Japan - is trending lower. The latest GDP figures from the EU show GDP growth slowing to 2.1% as of Q2 2018 compared with a recent high of 2.8% in Q3 2017. This, by the way, was the highest GDP growth rate in the EU since 2007. Significantly, the EU has been unable to fix the structural problems in its economy, and GDP growth has suffered as a result. This lackluster growth coupled with rising debt levels places the EU in a high-risk position during the next economic downturn.

GDP growth in China also has slowed down to 6.7% as of Q2 2018, which was slightly lower than economists' expectation of 6.8%. China has been slowing down for years, as claims by its government suggest that it is trying to manage a slowdown. We believe that the economy will slow down even faster than the government expects. Over the past decade, China has been the source of the largest demand for new oil. But as China's GDP growth slows, so will its demand for oil.

Japan's GDP growth has been anemic for more than two decades. Today is no different, despite efforts by both the government and the central bank to revive growth. Though Japan today maintains its position as the third-largest national economy, its trending slowdown will have a knock-on effect, slowing demand for oil.

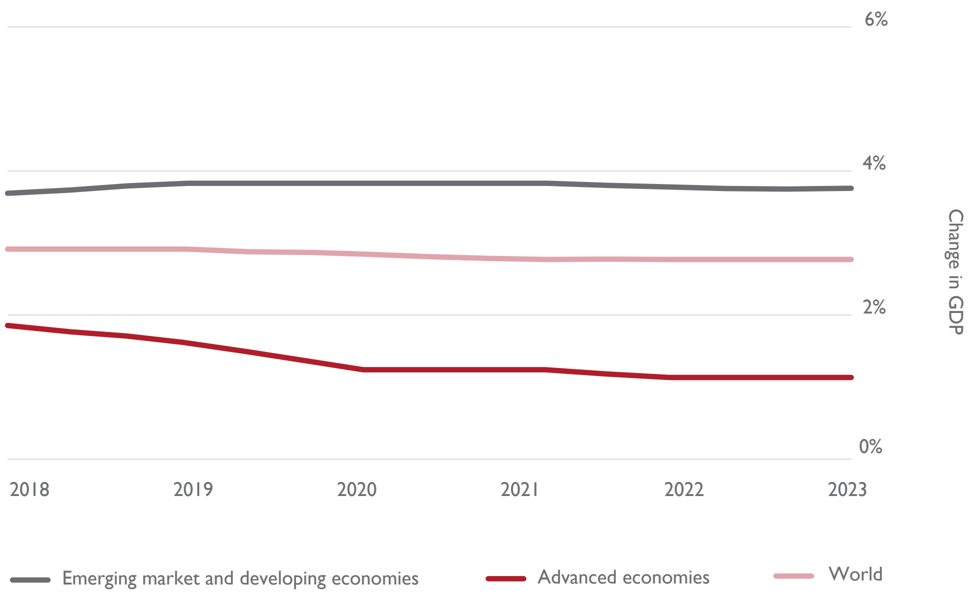
Other major economies, including South Korea, Brazil, and Turkey, are showing signs of weakness. A key market to watch is South Korea's, because it is a major global exporter. Over the past year, it has been reporting slower export growth and its GDP has been trending lower since 2016. Brazil, which recently emerged from its greatest recession in over 100 years, looks like it might be headed for another recession. Political turmoil, weakness in commodity prices and a sell-off in emerging markets has deteriorated Brazil's foreign currency reserves and weakened its currency, which has depreciated over 30% against the US dollar over the past year.

Turkey is in an even more precarious position. As we highlighted in the previous report, for more than a year Turkey has been flashing red warning signals over its financial position. It borrowed heavily in euros and dollars to finance its economic growth. Over the past year, its currency has depreciated 70% against the dollar making repayment of its massive debts impossible. We believe that Turkey today is in a financial crisis; we expect it to get worse, as we have yet to see any significant debt defaults or bankruptcies. The situation in Turkey will directly impact some financial institutions in Kuwait as, we will discuss in Section III.

In January 2018, both the IMF and World Bank raised their growth forecast for the global economy only to lower that forecast months later as the leading economic indicators were showing signs of weakness. Both organizations have continued to lower their global growth expectation, as can be seen in Figure 18.

FIGURE 18

Actual GDP growth rates in advanced economies compared with emerging economies and the world



Source: International Monetary Fund (IMF).

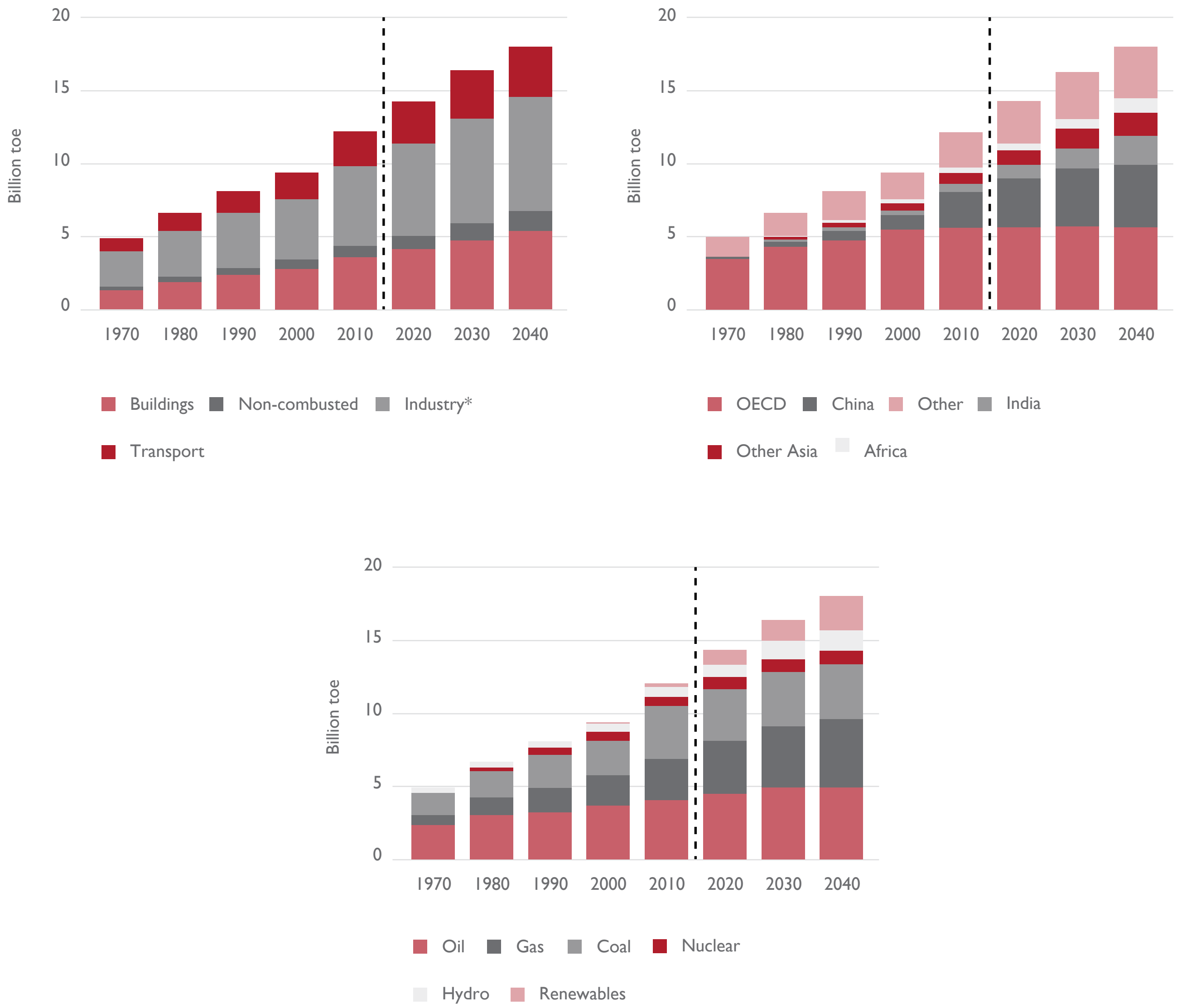
Both the IMF and the World Bank believe that the ongoing trade war between the US and China is to blame for deteriorating economic conditions. This, however, does not explain why the leading economies around the world have been showing signs of weakness for over a year, which is before the trade war began. In fact, when looking at the IMF five-year forecast for the global economy (Figure 18), there is no forecast for a recession. Since their inception, the IMF, World Bank and the Federal Reserve, along with the other leading central banks, have never predicted a recession and, therefore, their long-term economic forecasts are not reliable.

2. Shift away from fossil fuels

The move away from fossil fuels has been gaining momentum for some time. It was only recently, however, that this move started to affect demand for fossil fuels, and most specifically oil. On 1 January 2016, countries around the world agreed to the United Nations' 2030 Agenda for Sustainable Development. The agenda is comprised of 17 Sustainable Development Goals (SDGs). Over the next thirteen years, countries will mobilize efforts to end all forms of poverty, fight inequalities and tackle climate change. Goal number seven is "Affordable and Clean Energy." The goal targets a reduction in the use of fossil fuels and an increase in the use of renewables such as water, solar and wind power.

FIGURE 19

Forecasted change in energy demand by end use sector, region and fuel type in billions of tons of oil equivalent (toe)



Source: BP Energy Outlook 2018 Edition.

*Industry excludes non-combusted use of fuels

In addition to a unified global push to reduce oil consumption, changing demographics are affecting the demand. In particular, mature and developed economies such as Japan and the EU have seen demand for oil peak as the percentage of working-age populations decline. Consumption of oil has started declining in Japan and is expected to begin declining in the EU as early as 2018. That leaves China and India with the biggest increase in oil demand.

Africa and South America also have seen demand increase, but at a much smaller rate, which will not be enough to offset the decline from Japan and the EU.

The overall demographic trends along with the United Nations' SDGs will continue to put downward pressure on oil consumption rates which, in turn, will limit the upside potential of rising oil prices.

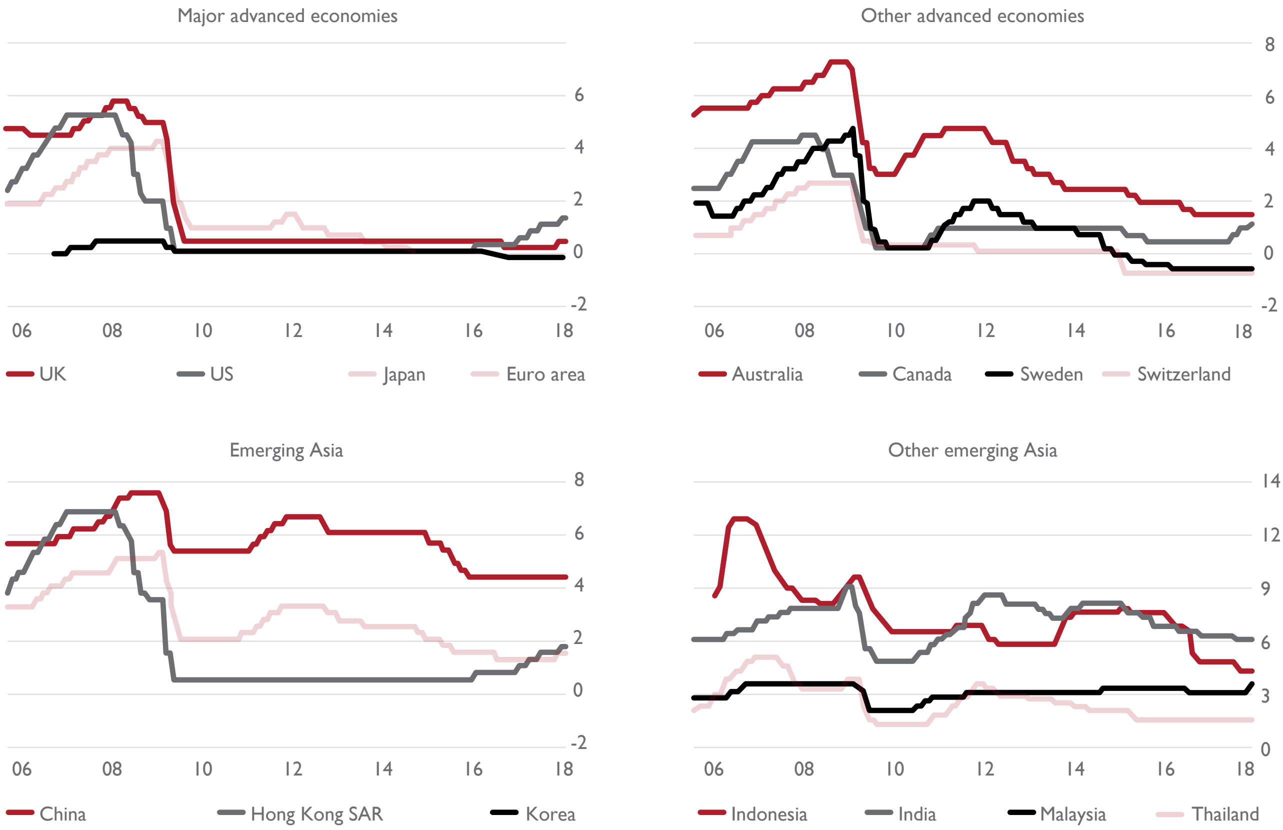
3. Rising interest rates

Since 2009, world-record low interest rates were set by the leading central banks as a way to stimulate the global economy after the financial crisis. Ten years later, most central banks still worry about raising rates, believing that their economies became too dependent on record-low interest rates. Some economists view this as a permanent state of central bank economic support and stimulus.

An alternative view is that these economies have become too dependent on this monetary stimulus because they are overburdened with debt. A slight rise in interest rates will risk pushing these economies into another financial crisis brought about by too much debt. Thus, instead of dealing with the debt problem, the safer solution for central banks

FIGURE 20

Effective central bank policy interest rates from 2005 to 2017



Source: BIS Quarterly Review, March 2018. Bank for International Settlements.

is to ensure debt payments are manageable by keeping rates low. The US remains as the only major central bank raising interest rates today. This has had a noticeable impact on emerging markets, which was evident this year when, first, Argentina and then Turkey saw their currencies collapse. Other emerging markets followed. Emerging markets were the first to feel the pain of rising rates due to their foreign currency borrowings. In times of economic growth, borrowing more can spur additional growth. On the flip side, a slowing economy will only amplify debt problems, especially if they are in other currencies. This is the case today.

Rising rates in the US will drive US dollars to seek safety back in the US, while emerging markets struggle to keep their currencies stable versus the dollar in order to be able to repay their debts. The reality is that many of these US dollar and euro debts taken out by these countries will head for default and will need to be restructured. In the case of Argentina, it has already received the approval for a USD 50 billion bailout from the IMF, the largest in the agency's history, only to see the currency continue to fall against the dollar.

We expect the problems in emerging markets to continue to get bigger as the U.S. Federal Reserve continues with its rising rate policy. This rising rate policy will continue so long as no developed countries are affected by it. Once they, too, are affected, the Federal Reserve will finally end this policy.

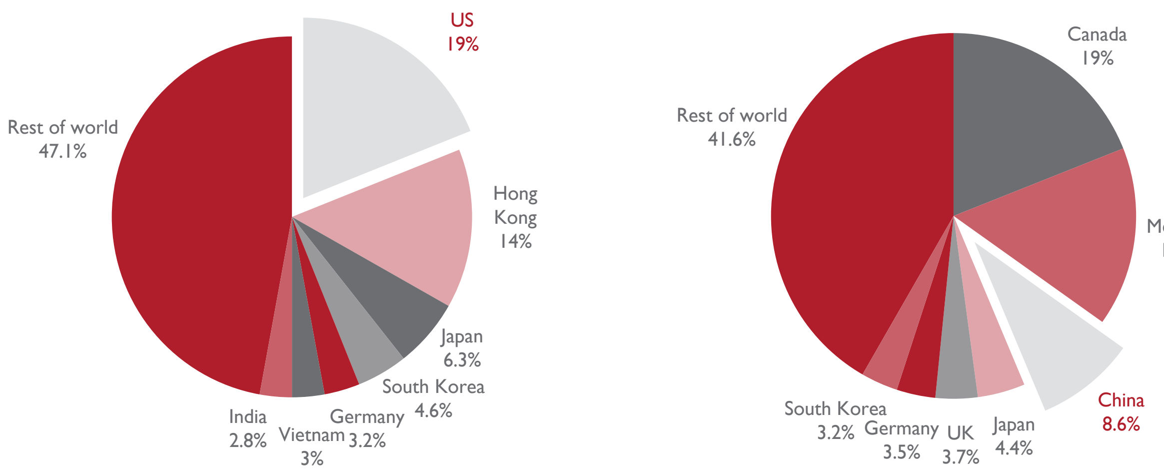
4. Global trade wars

Trade wars are not a problem on their own. They are a symptom of other problems in the global economy, namely, unsustainably high national debts coupled with lower than expected GDP growth. The current trade war between the US and China has been going on since March 2018 and has yet to affect global trade.

Higher tariffs between the two countries have been implemented in stages, as both sides try to negotiate an end to the dispute. This is one reason high tariffs have not yet affected the global economy.

FIGURE 21

Top export markets for China and the US, respectively, as a percentage of each country's total exports in 2017



Source: Trading Economics.

China's position, however, is weaker than that of the US. China is far more dependent on exporting to the U.S. than is the U.S. on exporting to China. Therefore, higher tariffs on both sides will disproportionately harm China.

Both countries are struggling to show a political win back home, which has caused the dispute to drag on far longer than expected. We believe that China has not tried to resolve the dispute more quickly because its government needs to pass the blame of its slowing economy on to an external party, in this case, the U.S. In the U.S.'s case, domestic political problems and weak export growth are behind President Trump's tough stance with China on trade. Overall, we expect the trend toward higher tariffs and an escalation of the trade war between the two countries to continue, with a high probability that it soon will expand to other countries. As it escalates, it will start to impact the global economy negatively which, in turn, could have a direct impact on oil prices and Kuwait's economy.

b. Synergies in GCC national development plans and their potential impact on the national economy

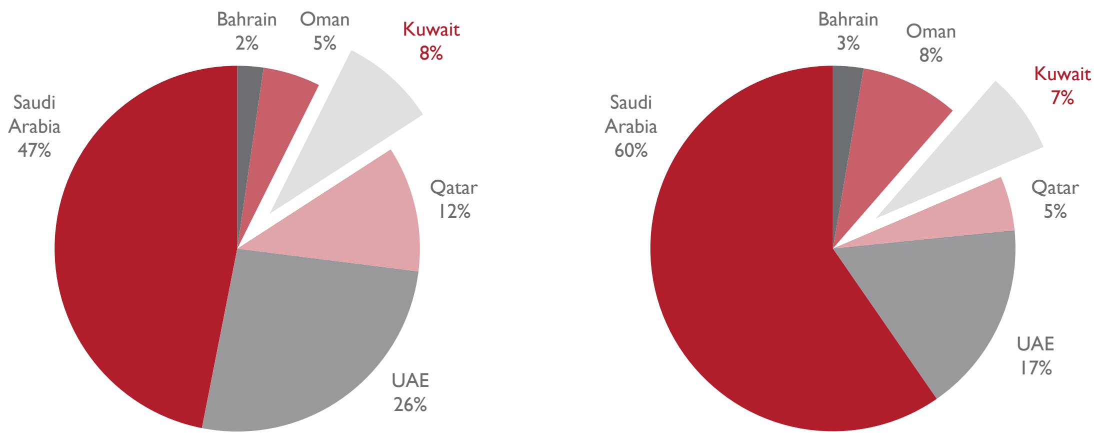
Kuwait is not alone in its 2035 Future Vision Plan. All other GCC countries have similar plans. In 2016, Saudi Arabia launched its Saudi Vision 2030 Plan. In 2007, Abu Dhabi launched Abu Dhabi Economic Vision 2030. In 2008, Qatar launched Qatar National Vision 2030 and that same year, Bahrain launched its Economic Vision 2030. In 1998, Oman launched its Vision 2020 and is currently in the final stages of launching Vision 2040.

All of these long-term development plans have similar themes and goals, the most important of which is to build a diversified economic base and move away from dependence on oil income. The GCC countries' similar economic and social challenges lead to a similarity in social and environmental goals, as well.

GCC development plans were not driven by governments' desire to diversify and modernize their economies, but rather because the status quo was no longer viable. High national population growth rates over the past decades (promoted by government policies) created higher-than-expected demand for social services, welfare programs and high-quality jobs. In addition, poor planning and wasteful use of resources placed enormous strain on infrastructure. These were the factors driving the urgent need for development plans. The GCC as an economic region is a large trading block representing a combined GDP of USD 1.4 trillion which would make it the 14th-largest economy in the world. Total GCC population is estimated to be 55 million, according to the United Nations.

FIGURE 22

GDP by country as a percentage of total GCC GDP as of Q1 2018

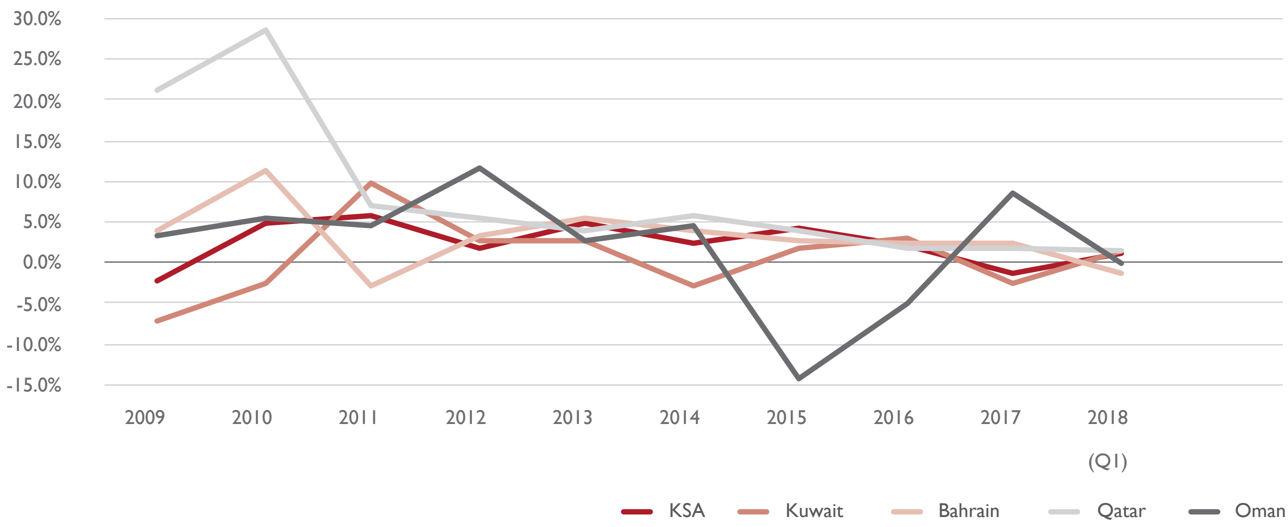


Source: Trading Economics.

Kuwait currently represents the fourth-largest economy in the GCC and also has the fourth-largest population. Until 2010, Kuwait had the third-largest economy in the GCC, but was overtaken that year by Qatar.

FIGURE 23

Annual GDP growth rates of GCC countries up to Q1 2018

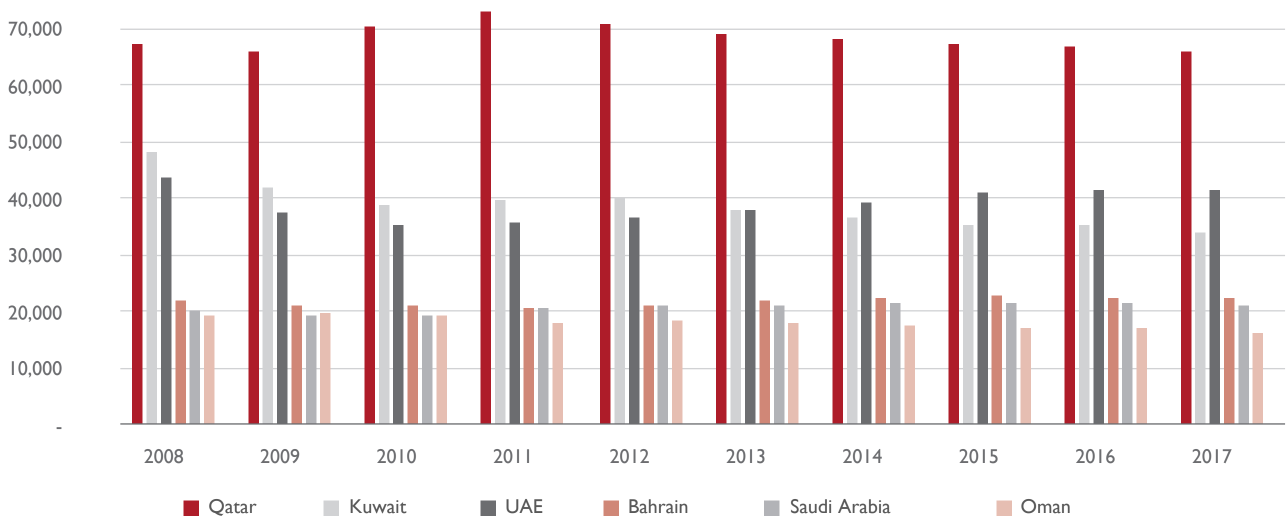


Source: Trading Economics.

GCC countries are homogenous culturally and socially, yet they differ in terms of their level of economic diversification and development. Saudi Arabia, the largest country, has a strong industrial and manufacturing base. The UAE and Qatar have spent tens of billions of dollars over the past decade developing their infrastructure. Oman, Qatar and the UAE have had targeted programs designed to develop their respective tourism industries. Overall, however, economic growth across GCC countries has been highly correlated. This is mainly due to the impact the oil industry still has on these economies.

FIGURE 24

Change in GDP per capita in GCC countries



Source: Trading Economics.

As a result of its rapid economic development, Qatar boasts the highest standard of living in the GCC in terms of GDP per capita (Figure 24). Kuwait's per capita GDP has been steadily declining for the past 10 years, and in 2014 it lost its second-place position in the GCC to the UAE.

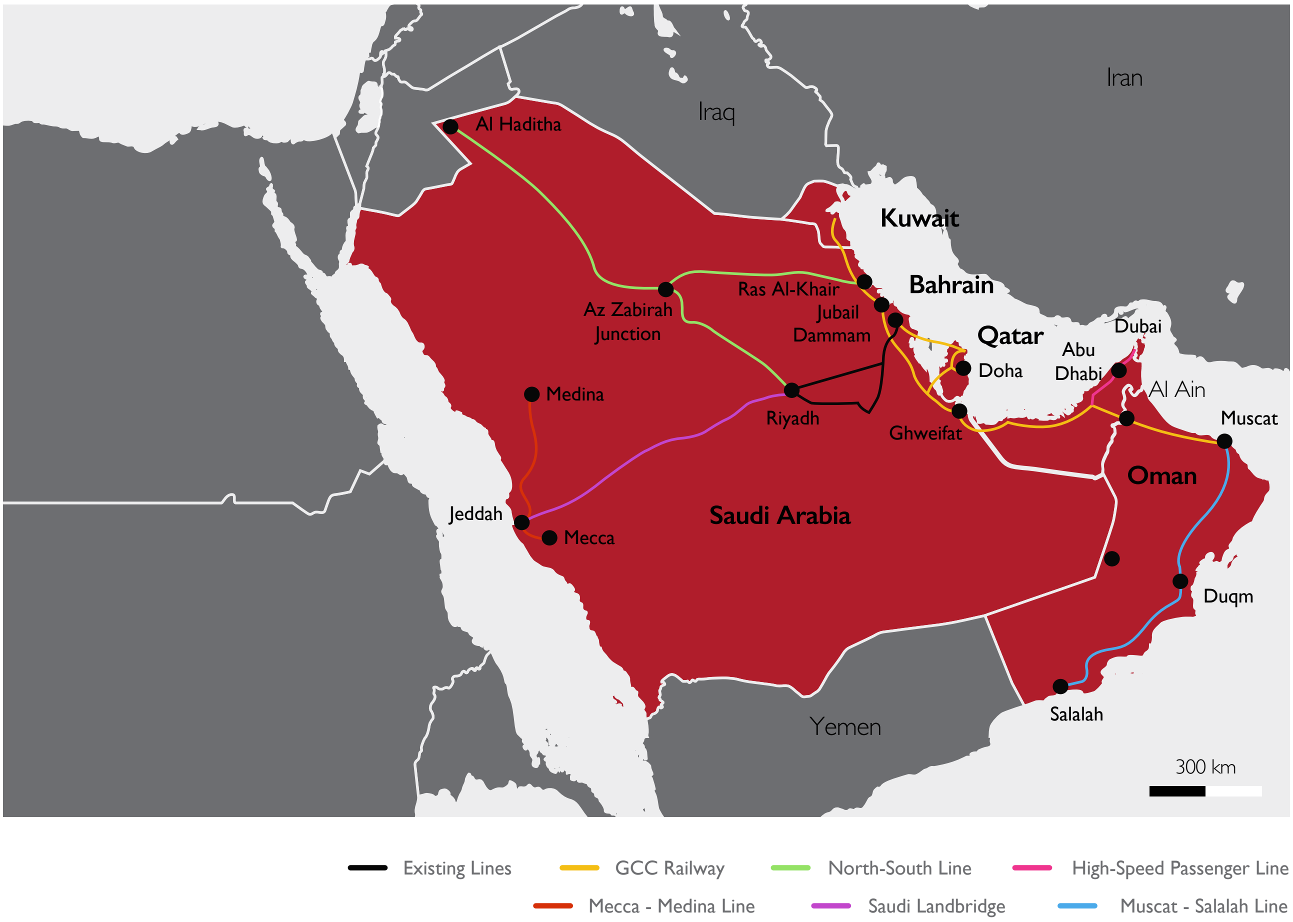
With these facts in mind, there are several synergies across regional development plans on which Kuwait can capitalize and support its stated targets. Specifically, there are three sectors where Kuwait can build on regional synergies: transportation and logistics; religious tourism; and support for small- to medium-sized enterprises (SMEs), which also drives FDI into the country. Below are more details on these three sectors.

1. Transportation and logistics

Kuwait wants to become the logistics and commercial hub of the northern Gulf, an objective that can be boosted by on-going regional development plans, such as the Gulf Railway Project. That project aims to connect all six GCC member states to a regional rail network spanning over 2,177 km in length. The railway network is expected to boost free movement in the GCC by providing unhindered travel from Kuwait to Oman. It is also expected boost intra-GCC trade by providing freight transport services. Once complete, the network by default and design will position Kuwait as the hub for the transportation of goods and services to northern Gulf countries, namely, Iran and Iraq.

FIGURE 25

The Gulf Cooperation Council's Planned Rail Network



Source: Reuters.

Portions of the network have already been built. Each country is responsible for implementing the portion of the project that lies within its territory and must construct its own railway lines and branches, stations and freight terminals. The cost will be shared among all countries in proportion to the length of the rail network in each country. As a result, the United Arab Emirates and Saudi Arabia will spend the most on the project, followed by Oman, Qatar, Kuwait and Bahrain.

The project is estimated to cost USD 250 billion and initially was scheduled for completion by 2021. However, the project has been derailed, at least temporarily, by financing challenges and a misalignment of interests among GCC members.

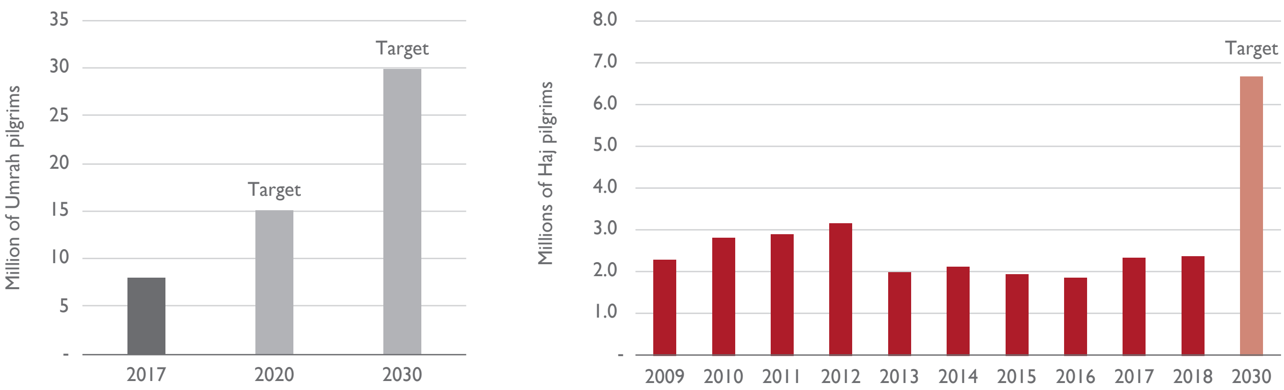
Other synergies in this area also exist. Ports along the Arabian Gulf have developed over the years to become world-class destinations for the transportation of goods around the world. These ports have focused on the shipment of goods among Asia, Africa and Europe, whereas only marginal effort has been put into place to address the growing shipping needs in the northern Gulf area. This is where the opportunity lies for Kuwait.

2. Haj and religious tourism

Tourism is among the key sectors highlighted in Kuwait's plans for development. Unlike other GCC countries that have set their sights on becoming global tourism destinations catering to Western tastes, Kuwait has more humble ambitions. It wants to focus on developing an industry that is more in line with its cultural and religious norms.

FIGURE 26

Actual number of Haj and Umrah visitors vs. target growth



Source: General Authority for Statistics (Saudi Arabia) and Oxford Business Group.

These goals are similar to the religious tourism objectives Saudi Arabia described in its own Vision 2030 plan. In 2016, Saudi Arabia announced an ambitious plan to more than triple the number of religious tourists in the country by 2030. To accommodate the projected growth, Saudi Arabia embarked on a massive building spree so large that for the last five years, the Kingdom had to reduce the number of annual Haj pilgrims. Now that much of the construction is complete, capacity is rising. Before the expansion began, Haj pilgrim capacity was around three million. By 2020, it is expected to rise to four million and by 2030, the Kingdom is targeting a capacity of 6.7 million.

Though the Haj pilgrimage is an annual event, Umrah is a year-round event. Last year, the Kingdom hosted approximately eight million Umrah pilgrims throughout the year, and it hopes to increase this to 15 million pilgrims by 2020 and 30 million by 2030.

What does this mean for Kuwait and where is the opportunity?

Thousands of Haj and Umrah pilgrims currently transit through Kuwait to or from Saudi Arabia; yet there has never been a concerted effort to have these travellers stop in Kuwait. Visa restrictions/limitations and a lack of organized tourism activities, especially cultural and religious-based, are obstacles to developing this sector. Unlike other GCC countries, such as the UAE and Qatar, which have developed into end destinations in their own right, Kuwait is far from being able to do so. Instead, the country now is largely a small transit station, and herein lies the opportunity.

As the drive to increase religious tourism gains momentum in Saudi Arabia, Kuwait stands to directly gain by the billions of dollars being put forward by the Saudi government in this sector. This niche tourism segment can be developed into a competitive advantage for Kuwait. Local sectors within Kuwait that stand to benefit from this include hospitality, retail, transportation (including air travel), and local tourism enterprises.

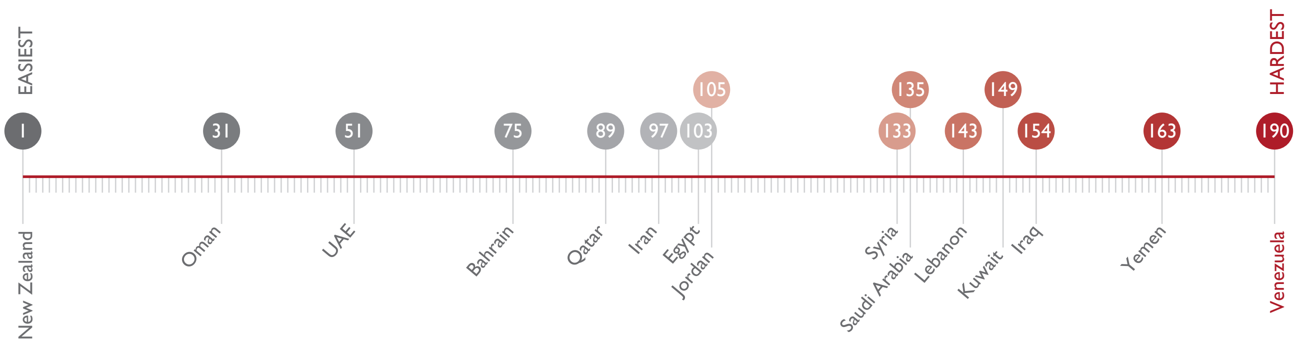
3. Support for SMEs helping drive FDI

Kuwait has long been a hotbed of entrepreneurial activity in spite of the numerous bureaucratic and governmental obstacles. Talabat, Carriage, Boutiqat, and Boxit are just a few examples of successful Kuwaiti start-ups that expanded regionally. Foreign investors acquired both Talabat and Carriage, a move that boosted the ambitions of other, local entrepreneurs.

The government only recently became serious about supporting the SME sector. In 2013, it launched the KD 2 billion National Fund for SME Development offering support and financing for new companies. In the private sector space, company accelerators and incubators have also been formed recently with the goal of inspiring the country's youth and turning Kuwait into a nation of innovators.
Despite these positive developments, much remains to be done in this sector. In 2017, the World Bank ranked Kuwait 149th in the world for the ease of starting a business, comparing unfavorably to neighboring countries such as Oman (31st), the UAE (51st) and even Syria (133rd).

FIGURE 27

World Bank Ease of Doing Business Ranking



Source: CNN and World Bank.

Numerous challenges remain for start-ups in Kuwait, a country not renowned for its streamlined regulatory framework. Even the much-hyped National Fund has fallen short of the expectations local entrepreneurs had for it. Regulatory barriers and bureaucracy have hamstrung the fund. But the fund recently went through a board change, which many hope will kick-start its activities.

With these obstacles in mind, the synergy here is twofold: first, all GCC countries have active programs to support the SME sector. Second, a vibrant SME sector also attracts foreign investors. There is an untapped opportunity in supporting local SMEs having a broader GCC- wide strategy. This, in turn, will draw GCC investors to Kuwaiti start-ups and encourage cross-border business development.

c. Negative impact of other GCC development plans on the success of Kuwait's development plans

While the other GCC development plans offer synergistic opportunities to Kuwait, they also pose risks. Below, we highlight four factors that can negatively impact Kuwait's plans.

1. Duplication of infrastructure and excess capacity

Over the past few decades, because each GCC member country has worked independently of the others, many projects have been duplicated. As well, the GCC member states' expressed goal of diversification is at risk of failing because there is no over-arching, coordinated vision regarding regional development.

In 2008, there were two aluminum smelters in the GCC, Alba (Bahrain) and DUBAL (UAE), with a total annual production capacity of 1.92 million metric tons. Attracted by high demand for aluminum across the GCC during the recent real estate building boom and perceived low- cost advantage due to cheap energy, other GCC countries saw this as an opportunity to move away from their dependence on a commodity (oil) as the primary economic income driver. Aluminum, however, is another commodity that has a similarly volatile price. The dominant producer of aluminum is China, the world's largest producer, having a total capacity of 33 million metric tons annually. China, realizing that it had built up too much capacity, has begun closing some smelting operations. In October 2017, China began shutting down 3.76 million metric tons of capacity.

In the GCC, on the other hand, aluminum capacity has been on the rise. Today, there are six smelters in the region: Alba (Bahrain), DUBAL (UAE), EMAL (UAE), Sohar (Oman), Qatalum (Qatar), and Ma'aden (Saudi Arabia), whose combined production capacity is approaching five million metric tons per year.ii Global aluminum prices have been trading similarly to oil. After reaching a record high in 2008, prices collapsed by about 70% in 2008, then recovered nearly 80% of the loss in 2011, only to collapse again in 2015 before subsequently experiencing a similar recovery to oil. In 2018,the price looks weak and is still over 25% below its high in 2008.

The expansion of aluminum capacity across the GCC is one example of how the member states have been working independently. This creates two problems. First, it leads to excess capacity in the region, which brings down prices and profits, eventually leading to cannibalization of the regional industry. Second, duplication of such projects is an inefficient use of capital and resources.

Another example of this "me too" strategy is in the number of free trade / economic zones across the GCC. Kuwait launched its free trade zone in 1999 after witnessing nearly two decades of free zone success in the UAE. Kuwait launched the free zone without a clear vision or a competitive advantage. As a result, it has not achieved the success its planners had envisioned.

Kuwait is not alone in trying to replicate the success the UAE, Dubai in particular, had with its free trade zones. Bahrain, Qatar, Oman and Saudi Arabia all have spent billions of dollars setting up free zones. In addition, within the UAE, the success of a project in one emirate led to other emirates wanting to create the same success. There are currently 37 free trade/economic zones in the UAE with a further nine currently being planned. The UAE is not only cannibalizing the free zone industry in the GCC, it is doing so in its own market. Over time, much of this investment will prove to have been wasted.

2. Rising competitiveness

Another problem created by the "me too" strategy across the GCC is the high-level of competitiveness in certain industries. There are two industries where GCC states have actively sought to compete rather than complement each other: the financial center sector and the aviation sector.

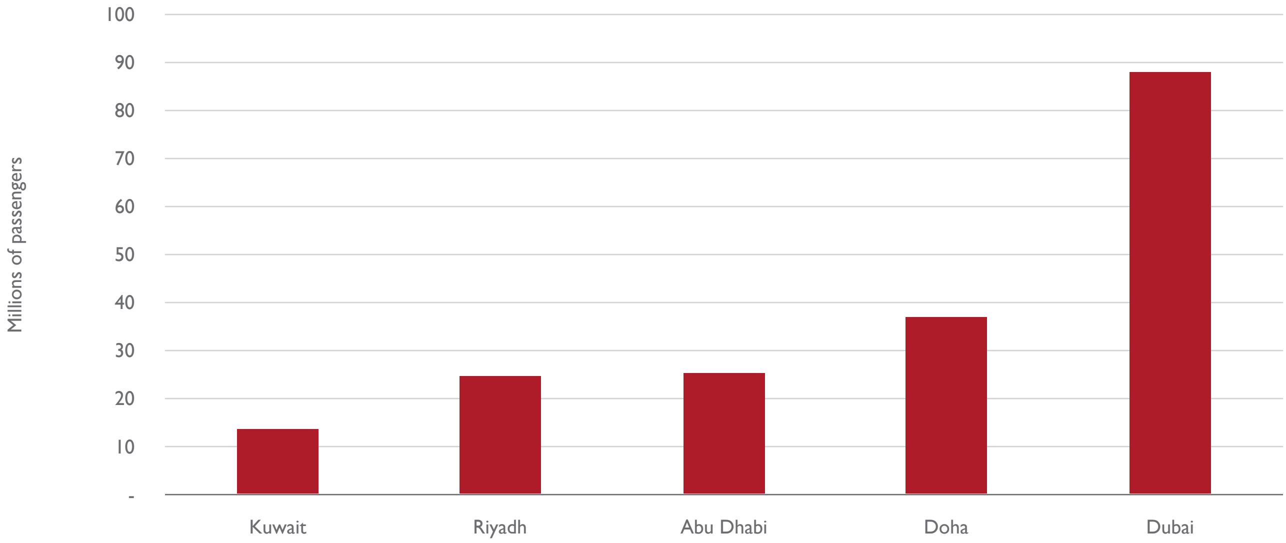
Kuwait is currently aiming to develop its own financial center. It will be doing so in an already-crowded field. There are five established financial centers in the region: Bahrain; Qatar Financial Centre (QFC); Dubai International Financial Centre (DIFC); Abu Dhabi Global Markets; and the King Abdullah Financial District in Riyadh.

Before the DIFC was established in 2004, Bahrain was the sole financial center in the GCC. Once Dubai set its sights on becoming a global financial center and put the resources behind it, the DIFC quickly displaced Bahrain to become the top financial center in the region. The success of this led Qatar and Abu Dhabi each to launch their own financial center, which then attracted the attention of Saudi Arabia. Today, the Kingdom is developing a massive financial center in Riyadh. All of these financial centers are essentially competing against one another.

A more publicized competitive sector in the GCC is the airline industry. Every GCC state has a target of developing its tourism and aviation sectors as part of their long-term development plans. At the core of this is the launch and support of national air carriers.

FIGURE 28

Total passenger traffic at select GCC Airports in 2017



Source: KUNA, Abu Dhabi Airports, Dubai Airports, Qatar Civil Aviation Authority and Riyadh Airport.

Dubai has clearly become the leader in this sector. It launched Emirates Airline in 1985 and built it up to become the largest airline in the world. In parallel, it turned Dubai into the largest international transportation hub in the world. In 1993, Qatar launched its own national carrier and inaugurated a new international airport in 2014 to handle the rapid rise in passenger traffic. In 2003, Abu Dhabi launched its national carried, Etihad Airways, following a strategy nearly identical to Dubai and Qatar.

Today, Saudi Vision 2030 is taking aim at these air transportation hubs as part of its strategy to expand its passenger capacity to reach its religious tourism goals. Kuwait is looking to follow its neighbors by inaugurating a much-anticipated new international airport and expanding the reach of its national carrier.

This over-investment in certain industries not only creates excess capacity, it also subtracts from the value these states are trying to create and diminishes their economic return. In the long-term, not all of these "me too" entities can co-exist in an overcrowded market.

3. Geopolitics

Geopolitical events are the often under-examined and unpredictable factors that affect the fate of national development plans. Kuwait's current development plan, for example, depends on regional political stability to succeed. One of the original objectives behind the 1981 formation of the Gulf Cooperation Council (GCC) was to foster trade and political stability in the region. This stability was shaken in June 2017 after Saudi Arabia, Bahrain and the UAE launched an economic and political blockade against Qatar. This was the most serious political rift in the organization's history. The economic blockade has affected trade and air travel among GCC members. It has placed Kuwait in a delicate mediation position that it has yet to resolve. The Qatar blockade has put regional economic cooperation plans, such as the GCC Railway project, in doubt.

A more pressing issue impacting Kuwait's plans are the political instability in Iraq and the growing political rift between Iran on one side and the U.S. and Saudi Arabia on the other side. Kuwait's ambition of becoming a commercial hub in the northern Gulf is in doubt as a result of this on- going escalation.

4. Failure of plan targets in other countries

The synergies with the other regional development plans - such as the development of transportation and logistics, regional religious tourism, support for SMEs and encouragement of cross-border FDI - can positively affect Kuwait's development plan. However, failure of any one of these plans can have the reverse effect, negatively impacting Kuwait's targets.

For example, Kuwait's tourism enhancement objective would be negatively impacted if Saudi Arabia has difficulty achieving its tourism objective. The geopolitical risks mentioned above can also cause a plan to fall short of its objective.

All four factors mentioned above pose a serious risk to Kuwait's development plans. Policymakers should seek ways to complement, rather than compete against, other regional plans.

III. Major financial and economic risks facing Kuwait and its financial sector

Kuwait's financial services sector is fairly robust and broad-based given the size of its economy. The Central Bank of Kuwait, the banking regulator for the country, takes a conservative approach, delivering more stringent oversight of local banks than regulators in other countries in the region. As such, Kuwait's banking system was able to weather the Global Financial Crisis better than the region's other banking systems.

The same is not true, however, for the country's finance and investment companies. Prior to 2008, oversight of these companies was much more relaxed than was oversight of the banks. This is primarily due to Kuwait's experience with past banking crises. In 2008 and 2009, finance and investment companies were hit very hard by collapsing oil prices, drops in regional real estate prices and a tightening of financing standards. This caused many companies to go into bankruptcy, forced liquidation of assets and a reorganization of debts. Today, this sector is in a much stronger position financially. But its has shrunk significantly from 2008, and it shows no signs of regaining its early, larger presence.

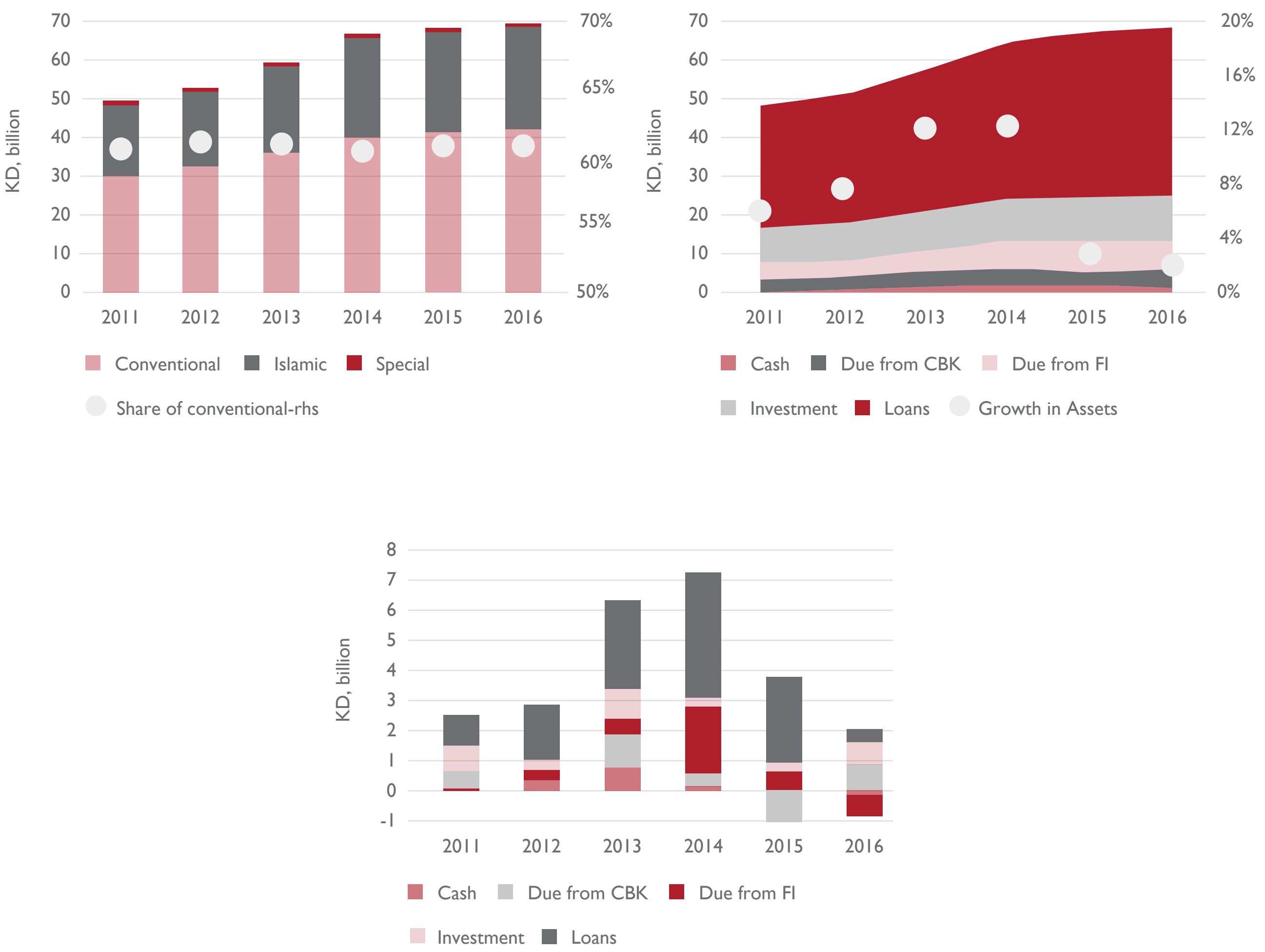
Though Kuwait's banks are stronger today than they were ten years ago, thanks to the central bank, they still face risks as the global economy heads into the next recession. The sector also will face risks should the government proceed with its plans to develop a financial center.

a. Current snapshot of the financial sector

The Central Bank of Kuwait currently supervises and regulates 11 Kuwaiti banks, 12 foreign banks and 68 finance and investment companies. The fall of oil prices in 2014 to 2016 had a direct impact on this sector, yet bank financial ratios remained strong and resilient.

FIGURE 29

Assets in the banking system and their trend

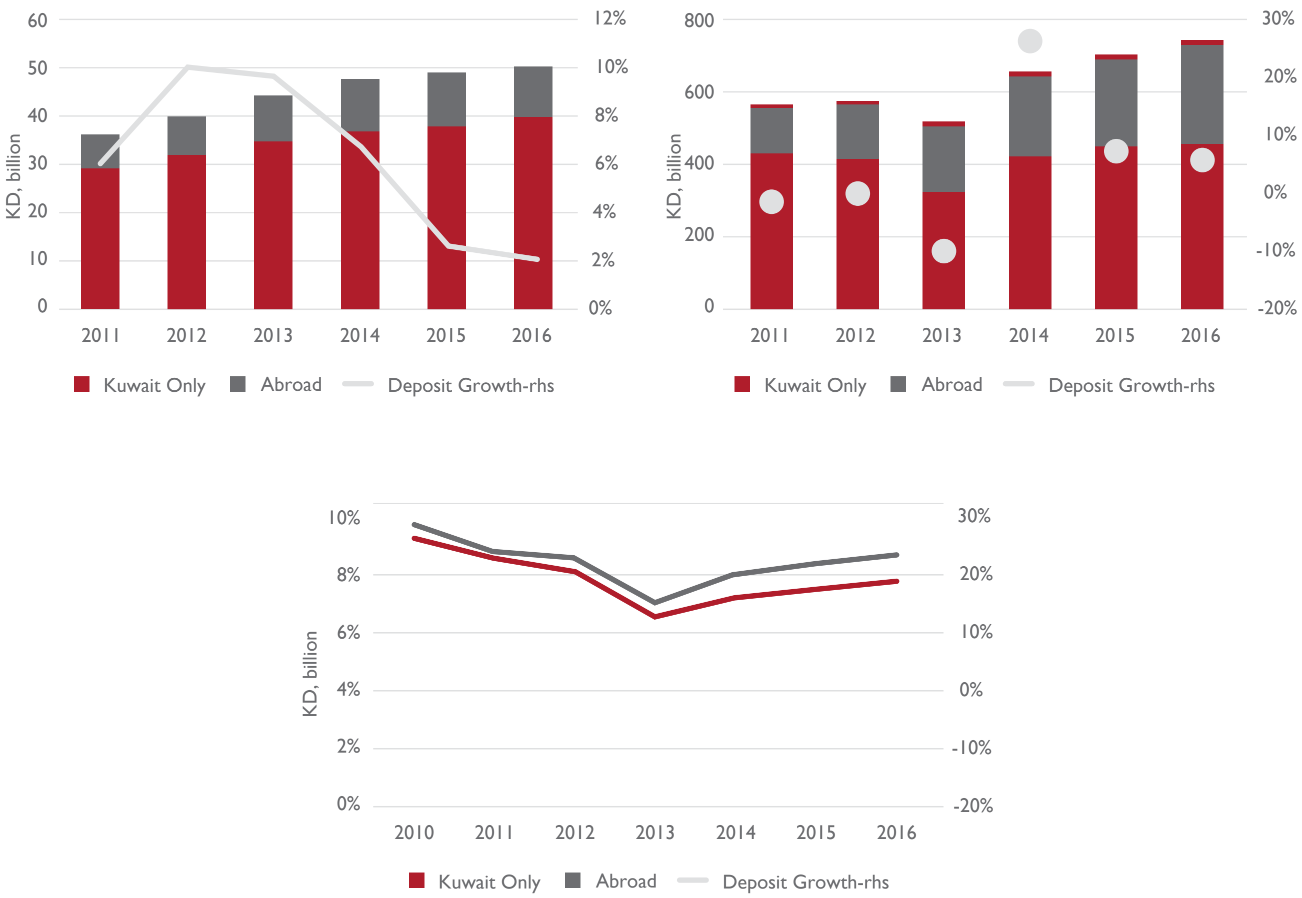


Source: Central Bank of Kuwait.

Since 2011, banks have been able to steadily grow their assets. Even during 2015 and 2016, growth slowed drastically, yet banks were able to maintain their asset levels. This was primarily because the Kuwaiti government did not remove its deposits from the banking system, unlike regional governments who needed to remove deposits to sustain their budgets during those years. Local banks also successfully maintained their ability to grow their loans to consumers and companies.

FIGURE 30

Deposits, net income and return on assets in the banking system

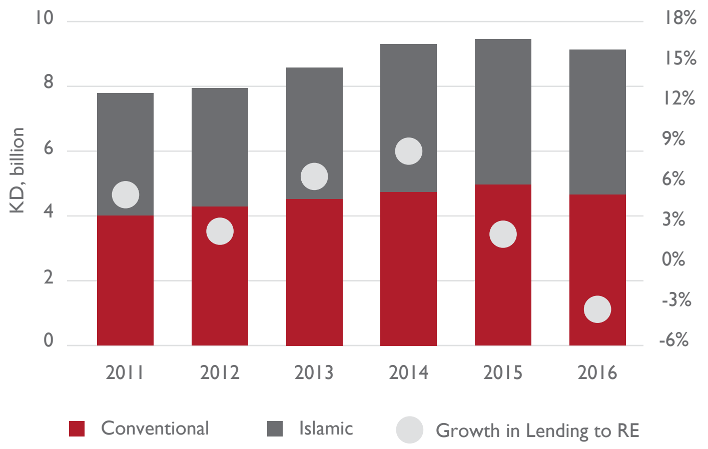


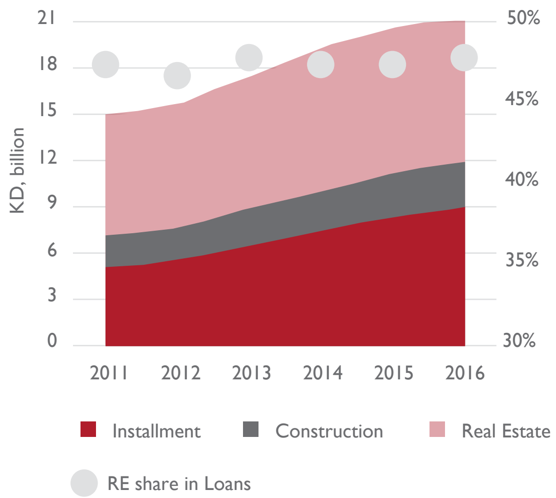
Source: Central Bank of Kuwait.

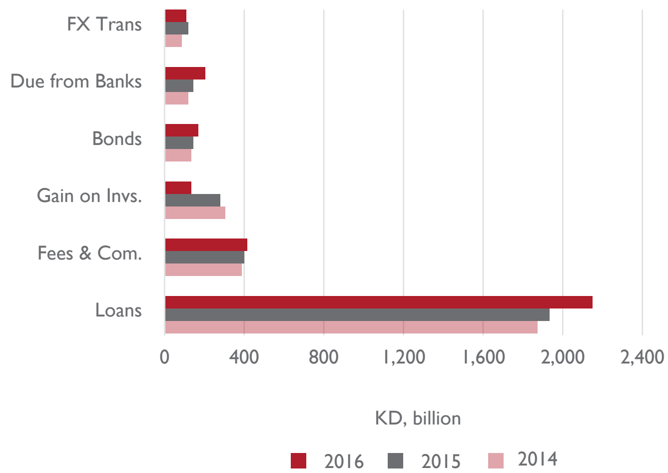
During 2015 and 2016 deposit growth did slow, but it did not turn negative, which was very positive for the banking sector overall. This allowed banks to sustain their growth in profits and return on equity.

FIGURE 31

Banks' lending to the real estate sector







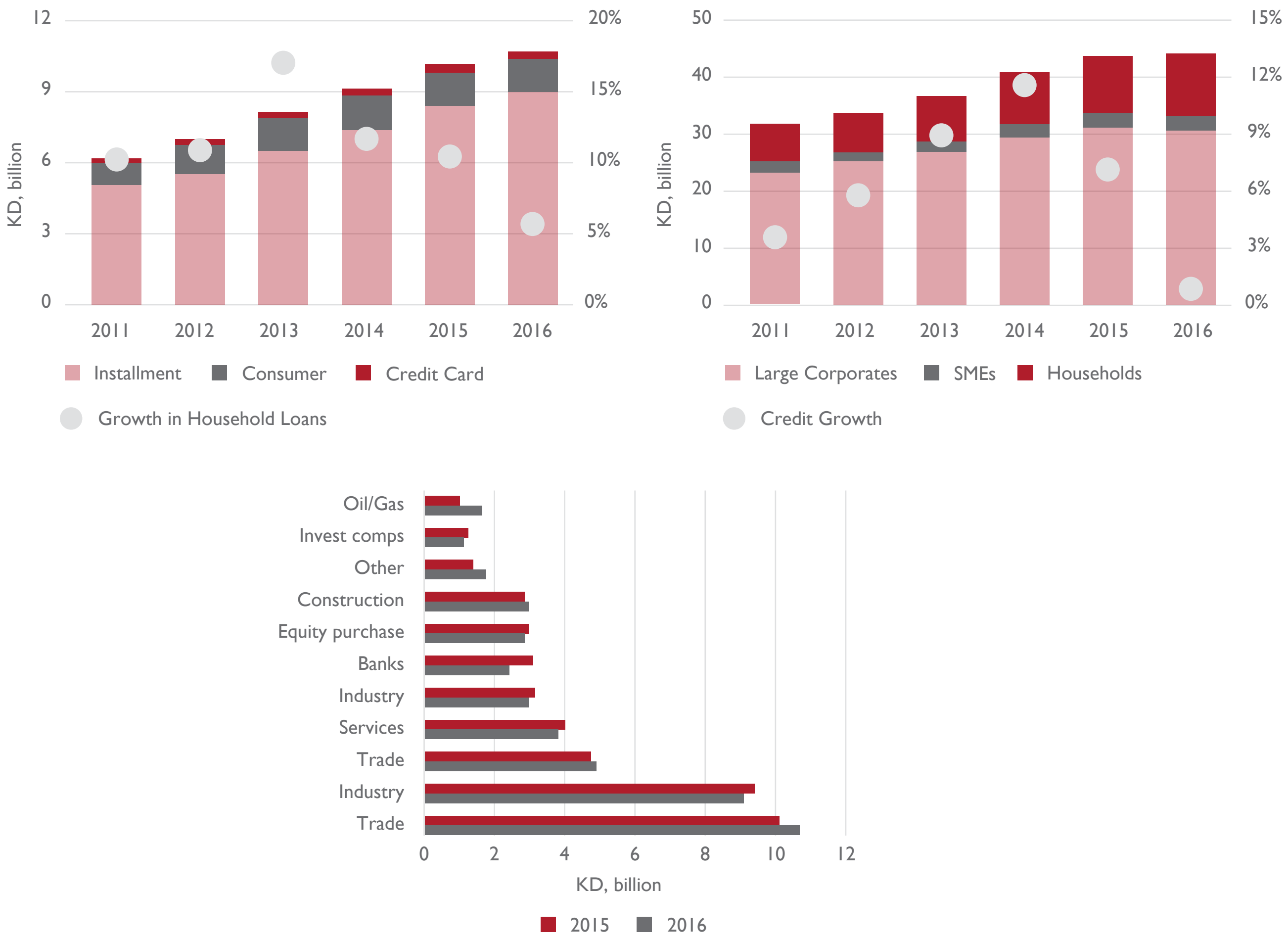
Source: Central Bank of Kuwait.

However, the bright spot for the banks over the past few years is evolving into a cause for concern. Kuwaiti banks have a high exposure level to the local real estate market. Approximately 50% of all bank loans are tied to the real estate sector along with a majority of banks' income, as depicted in Figure 31. The three leading international rating agencies, Fitch, Moody's and S&P, have raised this exposure risk in their assessment of Kuwaiti banks and encouraged them to diversify away from the real estate sector.

The gravitation towards real estate, however, has not occurred by choice. Over the last decade, government projects were slow to develop, family groups were still reeling from the debt loads they accumulated during the financial crisis and SMEs were deemed too risky to most banks. That left banks with few lending options; the real estate sector represented their best opportunity.

FIGURE 32

Banks' gross loans by borrow type



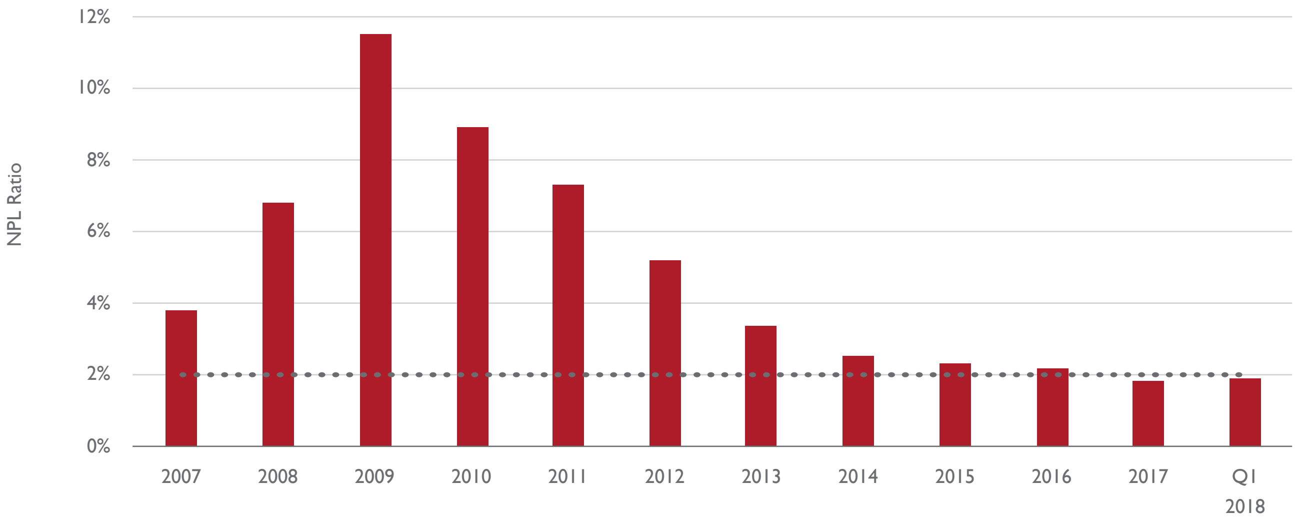
Source: Central Bank of Kuwait.

As can be seen in Figure 32, loans to households represent the biggest borrower group, followed by the real estate sector. It is important to note here that most of the loans to households are tied to real estate. In line with expectations, however, loan growth slowed during 2015 and 2016.

Throughout this period, loans to the SME sector remained small compared with overall loans in the banking sector. SMEs still represent the smallest borrower segment for banks, but it is growing.

FIGURE 33

Kuwait banking sector non-performing loans (NPLs) as a percentage of banks' total loans outstanding



Source: Central Bank of Kuwait.

The overall health of the Kuwaiti banking sector has shown continued signs of improvement since 2009. Record high non-performing loans (NPLs), which is the ratio of loans that are over 90 days past due to total loans outstanding, have come down significantly from 11.5% in 2009 to 1.9% as of Q1 2018. As a standard benchmark, banking regulators globally consider an NPL ratio of 2% or less to indicate that the country's banking system is strong and healthy.

FIGURE 34

Kuwaiti banking sector capital adequacy ratio (CAR) compared with CBK minimum target

Source: Central Bank of Kuwait.

Another measure of the financial sector's health is the Capital Adequacy Ratio. The Capital Adequacy Ratio (CAR) is a measure of a bank's available capital expressed as a percentage of a bank's risk- weighted credit exposures. The CAR is used to protect depositors and promote the stability and efficiency of the financial sector. Kuwait's banking sector has not had an issue with maintaining a high CAR, unlike European banks, which still today struggle to maintain the necessary ratios.

FIGURE 35

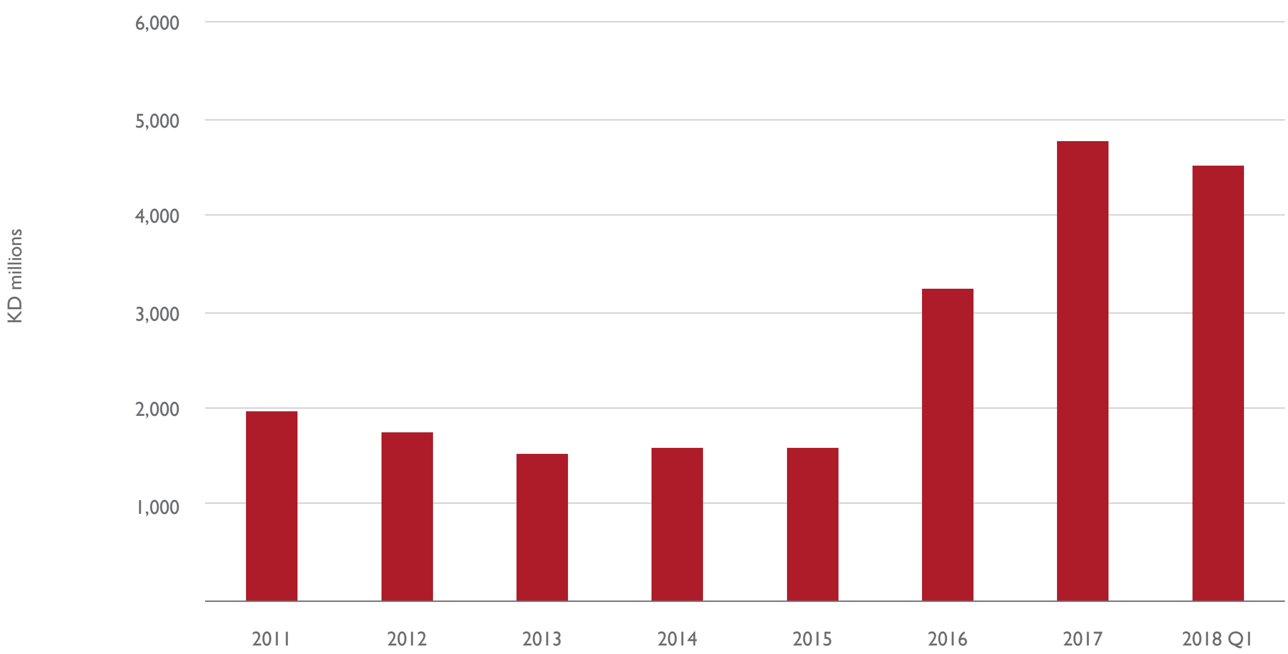
Kuwait banking sector loan growth from 2008 to June 2018

Source: Central Bank of Kuwait.

As can be seen in Figure 35, loan growth, though maintaining positive growth, has not risen to the high level it reached in 2008. This was primarily due to lending by banks to finance and investment companies as well as to family groups. This lending later turned out to be the cause of problems for the banking sector. Today, however, growth is in the low single-digits, which is below where it should be for a healthy, growing economy. Loan growth in the high single- digits would indicate a stronger economy.

FIGURE 36

Kuwait government bonds, treasuries and related instruments outstanding

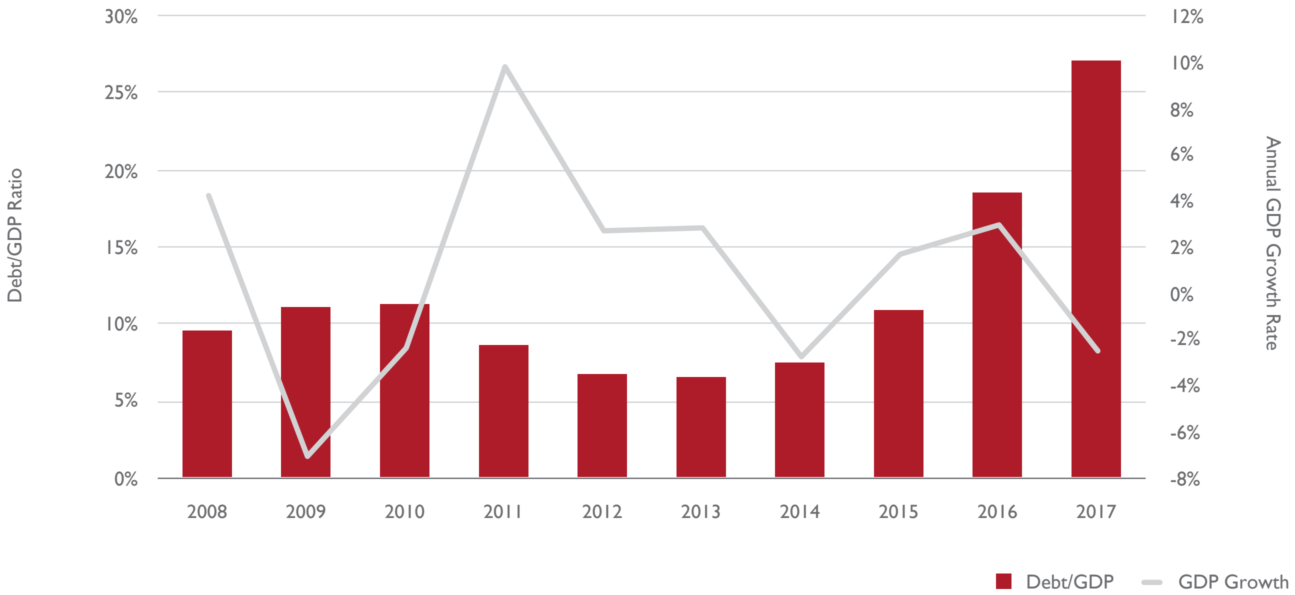


Source: Central Bank of Kuwait.

Government bonds, treasuries and tawarruq securities outstanding have been rising since 2016 (Figure 36). The driver behind this has been the government's budget-balancing in an environment of low oil prices. The banking sector has capitalized on the situation as a way to diversify its investments away from the real estate sector. There is high demand among Kuwaiti banks for government securities, and the banks have a strong appetite for financing government projects.

FIGURE 37

Kuwait government debt to GDP ratio compared with overall GDP growth



Source: Central Bank of Kuwait.

Total government debt outstanding is still relatively low - registering 27.1% of GDP - as can be seen in Figure 37. This low ratio combined with banks' strong appetite for government securities and for financing government projects means that the government should be able to maintain its funding as per the development plan under any economic scenario.

b. The national development plan and the financial sector

The current Development Plan calls for Kuwait to become an attractive financial hub for investment. Though we acknowledge the benefits of such a vision, certain prerequisites must be in place before that idea can become a reality.

Before discussing the prerequisites, we must first understand the driving forces motivating the development of a financial center. How would this center differentiate itself from regional competitors? In which segments of the financial services sector will it specialize? What would be its competitive advantage compared with other, established centers?

The five existing financial centers in the GCC are both years and billions of dollars ahead of Kuwait. Lacking a clear vision - and a niche or competitive advantage - Kuwait will not achieve its desired level of success. This can be seen among the existing centers in the region. In the last decade, Bahrain lost its place as the regional leader to Dubai. Since then, Abu Dhabi and Qatar have launched competing centers, but have had limited success.

The size of the regional economy, number of financial transactions and number of banks do not justify the number of financial centers in the GCC. Saudi Arabia, is taking a slightly different approach to that of the other countries. Its local economy provides its greatest competitive advantage because that, alone, can support its financial center. As for Kuwait, it must have a clear and differentiated vision from its peers in order to execute a successful financial center plan.

Prior to pushing ahead with the development of a financial center, the government and banking regulators should consider addressing these four issues:

1. Mergers

In 2008, there were two Kuwaiti banks among the largest 10 banks in the GCC. Today, there is only one. Banks in the region have been allowed to and, in fact, encouraged to merge and form larger banking groups. This is designed to foster global competitiveness. Banks in Kuwait have fallen behind their regional rivals, and now they are too small to compete regionally, much less globally. A successful financial hub would allow strong, local banks to compete against their regional peers.

2. Allow financial instruments to develop

Banks in Kuwait have a limited number of financial instruments in which to invest and offer, which places them at a competitive disadvantage from other banks in the region. A public secondary debt market, where corporate bonds and debt instruments can be traded, is virtually non-existent. This debt market frees up bank capital and provides additional financial investments to the public. There has only recently been a launch of government bonds and debt instruments as a result of the recent budget shortfall. The government should support this segment by issuing more debt instruments with local banks as the main beneficiaries. This will encourage the development a secondary market for these instruments.

There are too many restrictions on bank lending to homeowners. There is no mortgage law, and banks can only lend up to a maximum of KD 70,000 to each individual homeowner. The average single-family home in Kuwait costs three times this amount, which further exacerbates the housing crisis in the country. The enactment of a mortgage law and allowing banks to issue mortgages and allowing them to develop a secondary market for trading these instruments will enhance banks' balance sheets, profits and further develop local capital markets.

3. Loosen regulation on raising capital

One of the biggest obstacles facing SMEs is access to capital. The establishment of the National Fund in 2013 was a welcome step forward because it gave hope that SMEs would have access to capital. But challenges in raising that capital remain for these small- to medium-sized companies. The default solution at the moment is bank financing, but this is not always ideal for SMEs with little or no collateral. SMEs tend to be risker and bank financing is not suitable for them or for the banks.

Funds, similar to the National Fund, that pool together investor capital and have higher-risk appetites are needed in the market. Such funds would compete with the National Fund and others currently on the market. In addition, a secondary capital market can be developed for younger companies, similar to how alternative stock markets grew and flourished in other markets. To date, there is no secondary market for younger companies in the GCC.

4. Level the playing field

Eleven foreign banks are operating in Kuwait, but they are limited in the services they can offer, the type of customers they can target and the number of branches they can open. Kuwaiti policy makers pressured the Central Bank to institute the restrictions, fearful that foreign banks would out-compete the nation's own financial institutions. But if Kuwait is to be recognized as a financial hub, it must have a level playing field for all financial institutions operating in the country.

c. Risks facing the national economy and the financial sector and suggestions for mitigating these risks

In our previous report, we discussed in detail the global economic risks that can negatively impact the national economy. All of those issues remain present today, and they pose the same level of risk. In this report, however, we will discuss four major risks specific to Kuwait's financial sector and offer suggestions for mitigating those risks.

1. Collapse of oil prices

Over the past ten years, we witnessed the price of oil collapse twice. This phenomenon had never occurred in the past. Over the course of an 18-month period, from January 2007 to July 2008, the price of oil shot up nearly 200% reaching a record high of USD 143/bbl. This was an impressive rise by any standard.

FIGURE 38

Price of Brent Crude per barrel in USD from 2005 to September 2018 highlighting both oil price collapses

Source: Thomson Reuters.

It was then followed by the fastest price collapse in the commodity's history, falling more than 75% over the next five months to settle at around USD 34/bbl. No financial forecaster or economist had predicted such a collapse, yet it occurred.

It took one year for the price to recover above USD 80/bbl, where it stayed for the next four years. A second collapse began in June 2014, as prices fell more than 78% over the next 19 months - from USD 116/bbl to under USD 26/bbl in January 2016. It took nearly two years for the price to recover above USD 80/bbl. As can be seen in Figure 38, price collapses occur suddenly and the rate of the drop occurs more quickly than the rate of the preceding rise. Since 2008, the price of oil has not reached a new high. In fact, it has been unable to rise up above USD 100/bbl,- the point at which it had traded for nearly four years. The current price pattern, to us, suggests that a third price collapse is possible. If the previous patterns were to repeat, the price of oil would fall rapidly until reaching a lower low than occurred in January 2016. It would also mean that a price recovery to above USD 80/bbl would take longer than the previous recovery, which was approximately two years.

In other words, another price collapse would mean that the price of oil would stay lower for longer, which would put an enormous strain on government finances and the national economy. Any resulting slowdown in government spending would negatively impact the financial services sector. A slowdown in government spending would have a knock-on effect throughout the rest of the economy, impacting not only financial services, but also consumer spending and, ultimately, real estate prices. The Kuwaiti financial services sector could not sustain a significant drop in real estate prices, as they are tightly bound to the sector.

Risk mitigant: Oil prices will inevitably collapse, although the precise timing of a future fall is impossible to predict. The government can cushion the negative effects on the financial services sector by maintaining current spending levels. This would force the government to issue more debt in order to balance its budget. But in doing so, it will also support the financial services sector - which has the appetite to absorb this debt issuance. Increasing government debt instruments on banks' balance sheets also would help to sustain their asset quality in light of deteriorating asset quality in other sectors, namely, real estate and consumer credit.

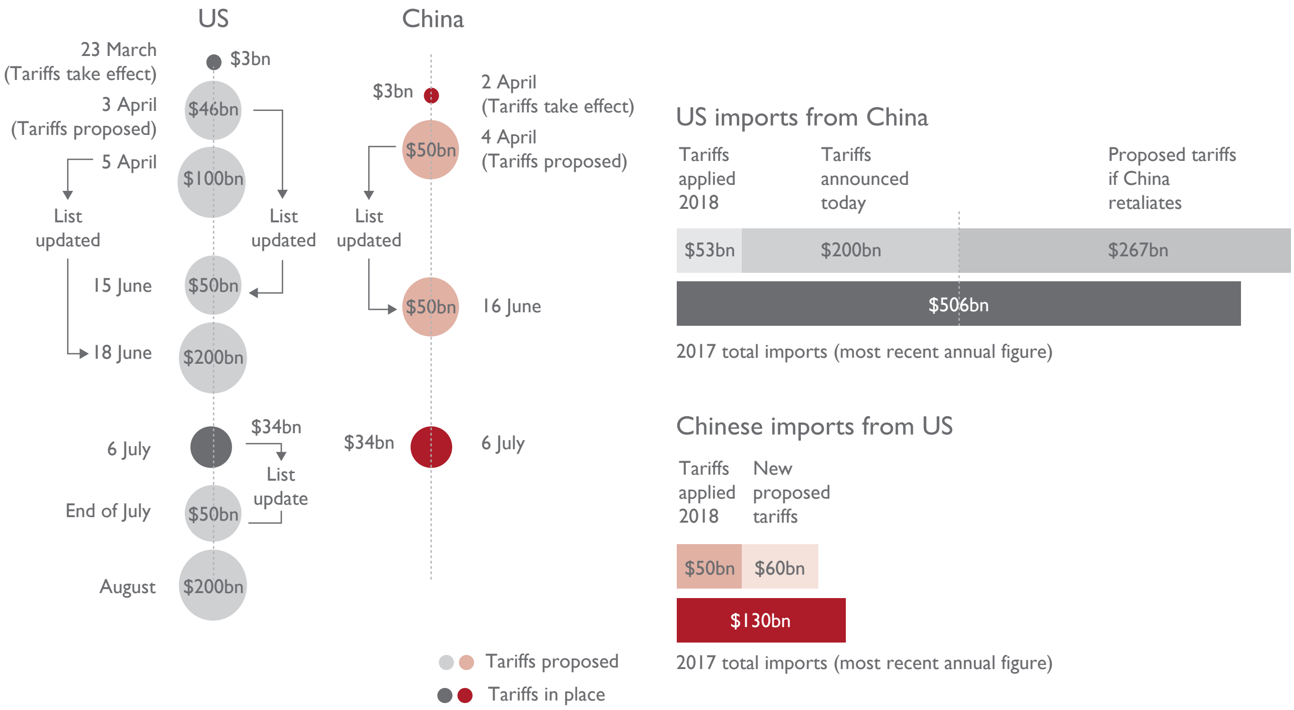
2. Global and regional trade wars

The global trade war that began in March 2018 continues to escalate beyond what any forecaster or economist expected. The war is primarily between the U.S. and China, but additional countries are also involved. Canada, Japan and Mexico, for example, are still trying to resolve their trade disputes with the U.S., which so far have yielded few results. There are also regional trade wars that have been going on for some time now, but have received little attention. Examples include the economic sanctions the U.S. and the EU (reluctantly) imposed on Russia in 2014, and the current U.S. campaign to isolate Iran and threaten Turkey with sanctions, all of which have an impact on global trade. Closer to home, the GCC has been in the middle of an internal dispute since 2017, pitting Saudi Arabia, Bahrain and the UAE against Qatar. Kuwait and Oman have been on the sideline of the disagreement, sometimes acting as mediators.

Every trade expert, economist and financial forecaster has predicted that these disputes will be resolved in a timely manner. Yet if we go back to 2014, none of these trade disputes have been resolved. In fact, they have been escalating. Therefore, it is puzzling to see why the specialists are predicting an end.

FIGURE 39

Escalation of the trade war between the US and China this year



Note: Data as of 18 September 2018

Source: Left: Peterson Institute for International Economics, BBC research; Right: US Census Bureau, BBC research

Every month, the trade war between the US and China escalates to a new level. And whenever that happens, experts tracking those developments predict that the trade hostilities will soon end in an agreement.

What many of these experts fail to realize is that these trade disputes are not isolated problems but are, instead, symptoms of a larger problem - historically lower growth rates combined with historically high debt levels. As these governments face rising economic tension, they seek to deflect internal blame externally. This is the driving force behind these trade wars and is why none of them have been resolved. The global growth outlook continues to decline, and the global debt level keeps rising. Therefore, we expect the current trade wars to escalate and spread to other countries and regions.

Risk mitigant: To our knowledge, Kuwait is not directly involved in any trade disputes. However, Kuwait's sovereign wealth fund has significant investments in China. The government and the Central Bank should understand the level of risk the fund faces should the trade war continue to escalate as well as the potential impact on its investments. In addition, China is the primary exporter of goods to Kuwait. In 2017, 16% or USD 5.5 billion of all imports into Kuwait came from China. Kuwaiti banks are involved in financing trade between the two countries. An escalating trade war could cause trading firms and banks in China to default on their obligations. The Central Bank of Kuwait should assess local bank exposure to this risk and offer options for minimizing it.

3. Emerging market crisis

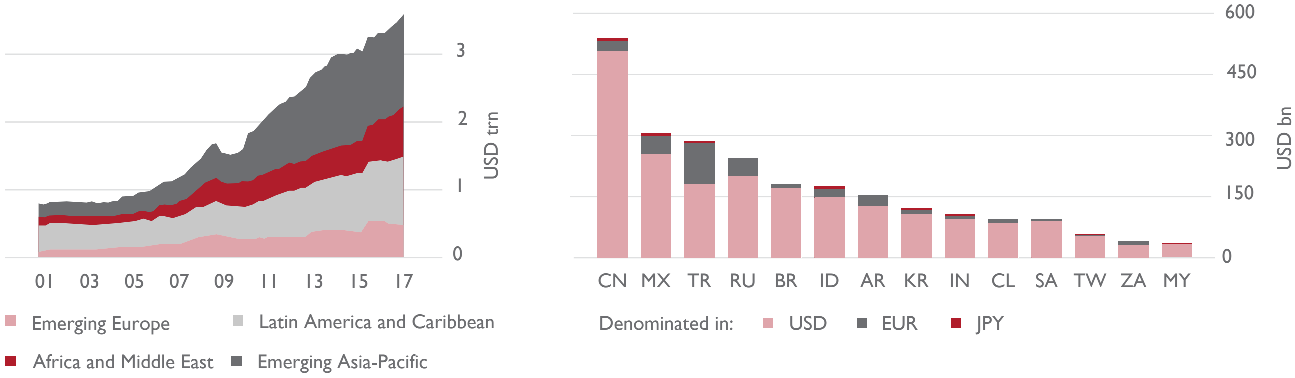
The risk of another crisis in emerging markets is coming from three fronts. First, a rising US dollar is good for emerging market exports, but it is terrible for their foreign debt payments, which today are at a record high. Second, emerging market currencies face more pressure due to rising current account deficits as a result of foreign money leaving these markets coupled with higher foreign debt payments. This explains the depreciation in emerging currencies this year versus the U.S. dollar, euro and pound.

FIGURE 40

Foreign currency credit to non-banks in emerging market economies (EME) from 2000 to 2017

US dollar-denominated credit by region

Foreign currency credits to selected EMEs[1]



[1]Amounts outstanding for the latest available data

Source: BIS Quarterly Review, March 2018. Bank for International Settlements.

Today, these economies are caught in a vicious cycle, which can be difficult to exit without causing a crisis. Third, many of these emerging markets depend on commodities as their main export and income-generator. Though the price of oil has recovered nicely from the lows of January 2016, other global commodities have not.

Argentina and Turkey are in a de facto financial crisis. The Argentine peso is down over 112% versus the dollar, and the Turkish lira is down over 70%. Even after a record USD 50 billion IMF bailout package, Argentina's economy and currency continue to spiral downward. Turkey is following behind, and other emerging markets also look very weak and are likely to follow suit - including Brazil, South Africa, India and Indonesia.

Risk mitigant: Three Kuwaiti banks have extensive banking operations in Turkey: Kuwait Finance House (KFH); National Bank of Kuwait (NBK); and Burgan Bank. KFH and Burgan Bank are highly exposed to Turkey, 30% of all KFH's lending is in Turkey and 19% of its profits were generated there. For Burgan, 25% of the bank's overall lending is in Turkey, and 18% of its profits were generated there. NBK has a lower exposure rate. All three banks claim to be properly hedged against the lira's depreciation, but we won't know for sure how effective it is until the banks report their earnings in the coming quarters. Rating agencies have already been downgrading Turkey and Turkish banks. NPLs are expected to rise and can cause a problem for these Kuwaiti banks. Due to their high loan exposure to Turkey, both KFH and Burgan may need support to shore up mounting losses from these operations. At this stage, it is too late to protect against this risk. But because the affected operations are outside of Kuwait, the Central Bank should not bailout these banks if they seek government assistance.

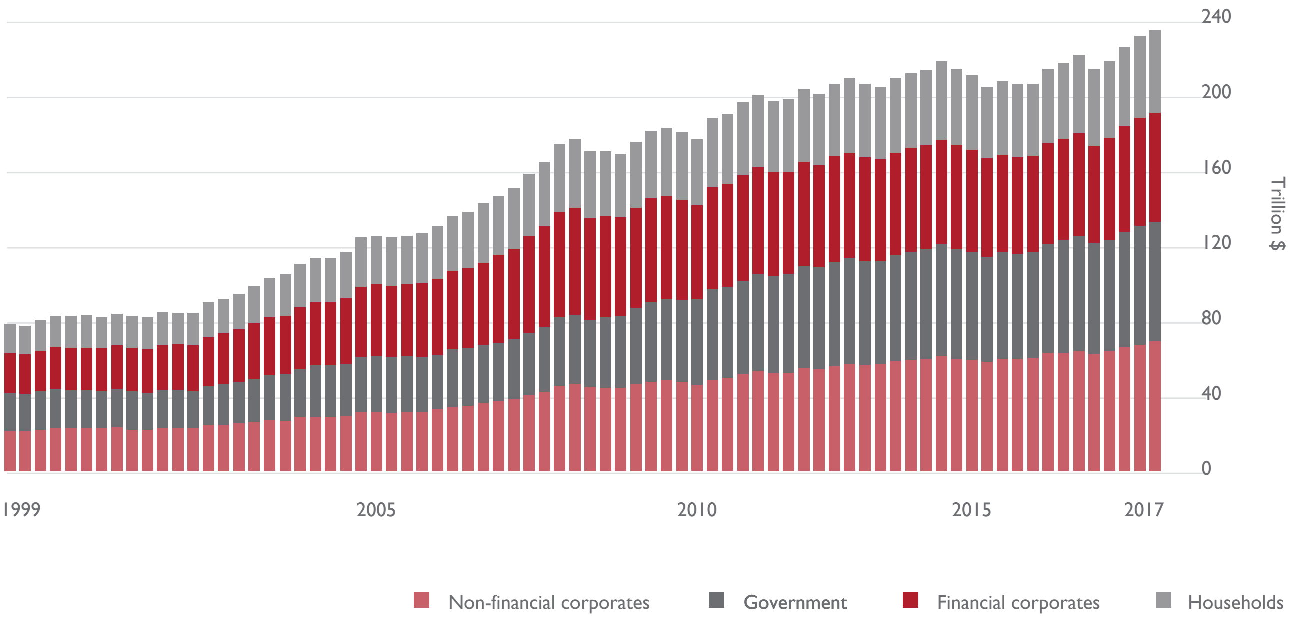
4. Global financial crisis

We have discussed extensively in the previous report the rising risks of another global financial crisis. The threat is real and growing, because the problems that caused the last crisis still exist and, in some cases, are even bigger.

The rise of global debt to an unsustainable level was one of the main causes of the last crisis, yet global debt continued rising to new record levels every year. Global debt is up over USD 70 trillion since 2008. High debt levels create instability in the financial system, which means that we are facing an even more unstable financial system than during previous financial crises. Total global debt reached USD 247 trillion in 2017, according to the Institute of International Finance (IIF). In other words, the world's debt to GDP ratios exceeds 300%.

FIGURE 41

Global debt reaches a new record high



Source: Institute of International Finance (IIF).

The world's leading central banks and international agencies, such as the IMF and World Bank, continue to state that the global financial system is safer today than it was a decade earlier, but they cannot convincingly explain why the largest economies still need economic stimulus a decade after the crisis. The reality is that economies are weaker today and never regained their growth momentum. Though the global banking system may have been saved, the solutions deployed to save it have created problems elsewhere. Let's not forget that a central bank has never forecasted a recession or predicted a crisis. As such, they have never been able to avert a crisis. They are reactive, not proactive. We cannot expect them to foresee another global crisis.

Risk mitigant: Another global financial crisis will directly impact the national economy, the financial services sector and the sovereign wealth fund. Such a crisis cannot be avoided, but lessons from past crises will provide suggested risk mitigants for a future crisis. For the national economy, a global crisis will result in a lower global GDP that, in turn, will cause oil prices to fall. The government's initial reaction may be to cut spending and development programs, but that would be the wrong solution. Instead, the government should continue its spending programs, which would support the national economy and steer it away from a deep recession. The financial services sector and the sovereign wealth fund need to assess their exposure to global banks and risky financial instruments (such as derivatives) and try to limit them. The sovereign fund should seek to increase its exposure to the local market as a means of avoiding riskier investment in other countries and as a way to support both the national economy and the development plan.

IV. Suggestions for managing the sovereign wealth fund and national financial sector during a prolonged downturn in the price of oil

In this section, we will offer suggestions for managing the sovereign wealth fund and the financial services sector during a prolonged downturn in oil prices. Some suggestions were already given in previous sections, but we will summarize them again here. Before offering these suggestions, however, it is important to understand why we feel that there is a risk of a prolonged downturn in oil prices.

a. Causes for concern on the future outlook of the price of oil

The two main types of drivers affecting the price of oil, as explained in the previous report, are fundamental (supply/demand) and market trading/speculating. Traders and speculators trade oil based on their expectations of future supply and demand of oil, not on actual results. Therefore, their views on where oil is heading drives them in unison to buy or sell oil. This market psychology, combined with modern financial instruments such as derivatives, drives the direction of oil prices more than does actual supply and demand. OPEC acknowledged this during the last oil price collapse when it asked hedge funds for help in supporting the price of oil. The price of oil cannot be sustained today without these market speculators.

Therefore, we must also look to the fundamental side to see where these speculators see the price of oil heading. On a fundamental basis, China has been the main driver of demand over the last decade. But in the coming decade, China will be unable to further spur growth (see previous report). In addition, there are technological and regulatory changes taking place in advanced economies. These changes are going to negatively affect the demand for oil in what can best be described as a paradigm shift towards other energy resources. This leaves the future demand for oil in its weakest position in living memory. On the supply side, OPEC has been unable to increase production to gain market share. Instead, the US has stepped in as the world's main producer of new supply and is expected to gain a larger share of the market in the coming years.

FIGURE 42

Price of Brent Crude per barrel in USD from 2005 to September 2018 and forecasted thereafter

Source: Thomson Reuters.

In addition, because we are at a late stage in the economic expansion cycle, any further upside in the price of oil will be limited. This should further dampen any jump in prices. Once the economic expansion cycle changes over to a contractionary cycle, expect the price of oil to decline substantially from its current level. In the event of a major geopolitical event such as a war or a disruption of supplies, the potential exists for price shocks to the upside.

Downside price shocks also pose a risk in the event that a regional or global recession sparks another financial crisis. In such a case, we would expect the price of Brent Crude to fall below its previous crisis level of USD 26/bbl. And, as stated in the previous section, looking at the previous two oil price collapses, each subsequent price recovery has taken longer than the preceding one. This also supports our view that the next oil price collapse will require a recovery period that exceeds two years.

For these reasons, Kuwait should have a plan for managing its economy under a low oil price scenario. This goes against the advice from other organizations, which expect oil prices to remain relatively stable. In this regard, it would be advisable to have a plan for managing the economy in multiple scenarios (positive and negative).

b. Suggestions for managing the sovereign wealth fund

To prepare the sovereign wealth fund for a scenario of lower oil prices for more than two years, we would suggest the following:

- The goal of the sovereign wealth fund needs to be clarified. In January 2017, the Managing Director of the Kuwait Investment Authority (KIA) publicly stated that the KIA must pursue riskier investments in order to maintain its desired rate of returniii. This statement should have sparked concern from the government. The sovereign wealth fund is not a pension fund with minimum-return objectives. It is a long-term wealth preservation fund for Kuwait. Its goal should be to preserve the national wealth and not to seek out higher returns - which today means taking higher investment risks than it should. It also means that during the next global recession or crisis, the fund will lose more than expected.
- The fund has recently boosted its investments in early-stage venture companies and private equity, both of which present a higher risk. Having a small exposure to this asset class can be beneficial, especially if it is integrated into the national Development Plan, i.e. used for technology transfer. However, increasing investment in this sector for the sole purpose of chasing higher returns is an incorrect strategy.
- The fund currently manages only 1-2% of its total portfolio, meaning that it is exposed to the risk of the external managers. If a manager, such as Lehman Brothers, were to fail, what would be the risk to the national wealth? The fund should limit its exposure to higher-risk financial institutions, especially the largest global banks. The large global fund managers (non-banks) are safer.
- Increase the percentage of funds managed in-house, which will also develop national talent and expertise in this field.
- Develop a sustainable investment program for alternative energies that is distinct from oil investments.

c. Suggestions for reducing the impact on the financial sector

The financial services sector in the country is stable and in a strong position. However, it is highly dependent on government spending and stable oil prices. Our suggestions follow for strengthening the financial services sector in order to prepare it for a prolonged slump in oil prices and to become a financial services center:

- Encourage mergers of local banks to strengthen their financial standing.
- Develop a deeper understanding of their exposure to emerging markets and ensure that risks are properly hedged.
- Reduce exposure to high-risk global financial institutions. Many local banks have treasury monies parked at global financial institutions. These funds, in our opinion, are risky and should be moved to safer institutions.
- Promote, through laws and regulation, the development of new financial instruments that will benefit the local market, such as a mortgage law, securitization law and an alternative capital market. This will provide new sources of revenue for the financial sector and make it less dependent on government spending.
- As the price of oil falls, the government should issue local debt instruments in order to maintain current spending levels. It also should provide new investment instruments for the financial sector and support the development of a secondary market for trading such instruments.
- Offer local financial institutions a larger slice of financing of government projects. In the past, local banks have complained that the government was giving the largest portion of financing to foreign banks out of fear that local banks will become too exposed to government projects. During a prolonged downturn in oil prices, local banks will need new projects to finance.
- Allow existing foreign banks in the country to compete with local banks. This will prepare local banks for opening up the market as a financial center in the future.

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Appendix

A. Key Economic Figures
B. Economic Forecasting Scenarios

APPENDIX A

Key Economic Figures

Indicator	Last	Reference	Previous	Frequency
GDP Annual Growth Rate	1.60%	18-Mar	-2.5	Quarterly
GDP	120 USD Billion	17-Dec	111	Yearly
GDP Constant Prices	10043 KWD Million	18-Mar	10158	Quarterly
Gross Fixed Capital Formation	9045 KWD Million	16-Dec	8580	Yearly
GDP per capita	33546 USD	17-Dec	35251	Yearly
GDP per capita PPP	65530 USD	17-Dec	68862	Yearly
GDP Growth Rate	-1.10%	18-Mar	3.2	Quarterly
Unemployment Rate	2.08%	17-Dec	2.11	Yearly
Population	4.1 Million	17-Dec	4.1	Yearly
Labor Force Participation Rate	69%	17-Dec	69.6	Yearly
Inflation Rate	0.80%	18-Jul	0.5	Monthly
Producer Prices	136 Index Points	18-Mar	136	Monthly
Consumer Price Index CPI	113 Index Points	18-Jul	113	Monthly
CPI Transportation	120 Index Points	18-Jul	120	Monthly
Food Inflation	1.21%	18-Jul	0.1	Monthly
Inflation Rate Mom	0.18%	18-Jul	0.3	Monthly
Interest Rate	3%	18-Aug	3	Daily
Money Supply M1	10674 KWD Million	18-Jul	10866	Monthly
Money Supply M2	38036 KWD Million	18-Jul	38419	Monthly
Money Supply M3	38036 KWD Million	18-Jul	38419	Monthly
Deposit Interest Rate	1.60%	17-Dec	1.6	Yearly
Banks Balance Sheet	64481 KWD Million	18-Jul	64632	Monthly
Central Bank Balance Sheet	10491 KWD Million	18-Jul	10962	Monthly
Foreign Exchange Reserves	-610 KWD million	Dec/17	-1100	Yearly
Interbank Rate	1.56%	18-Sep	1.56	Daily
Loan Growth	2.40%	18-Jul	1.6	Monthly
Loans To Private Sector	38132 KWD Million	18-Jul	37956	Monthly
Reverse Repo Rate	2%	18-Jul	2	Monthly
Balance of Trade	2310 KWD Million	18-Mar	1938	Quarterly
Exports	4936 KWD Million	18-Mar	4636	Quarterly
Imports	2626 KWD Million	18-Mar	2698	Quarterly
Current Account	1680 KWD Million	18-Mar	1158	Quarterly
Current Account to GDP	1.97%	17-Dec	-4.51	Yearly
Capital Flows	-6649 KWD Million	Dec/17	-1645	Yearly
Remittances	1029 KWD Million	18-Mar	995	Quarterly
Tourist Arrivals	7055 Thousand	16-Dec	6941	Yearly
Gold Reserves	79 Tonnes	18-Jun	79	Quarterly
Crude Oil Production	2800 BBL/D/1K	18-Aug	2800	Monthly

Source: Trading Economics and Central Bank of Kuwait.

SCENARIO 1

World Bank forecast vs. Oxford Economics Baseline Scenario

		2018	2019	2020	2021	2022
World oil price, Brent crude spot, $pb	BASELINE	77.7	82	75.8	73.2	75.3
World oil price, Brent crude spot, $pb	SCENARIO	70	69	65.4	65.4	65.4
Scenario (baseline=100)	SCENARIO	90.1	84.1	86.3	89.3	86.9
Government revenue, oil	BASELINE	17,803.50	21,195.60	21,201.70	21,039.00	21,254.30
Government revenue, oil	SCENARIO	16,063.00	17,918.40	18,379.90	18,865.10	18,544.60
Scenario (baseline=100)	SCENARIO	90.2	84.5	86.7	89.7	87.3
Government revenue, non-oil	BASELINE	2,297.40	3,135.20	3,600.60	4,049.30	4,586.30
Government revenue, non-oil	SCENARIO	2,262.20	3,044.60	3,484.80	3,913.90	4,403.60
Scenario (baseline=100)	SCENARIO	98.5	97.1	96.8	96.7	96
Government revenue, total, LCU	BASELINE	20,100.90	24,330.80	24,802.40	25,088.30	25,840.60
Government revenue, total, LCU	SCENARIO	18,325.10	20,963.00	21,864.70	22,779.10	22,948.20
Scenario (baseline=100)	SCENARIO	91.2	86.2	88.2	90.8	88.8
Government expenditure, total, LCU	BASELINE	18,796.60	19,848.00	20,912.80	22,024.00	23,137.30
Government expenditure, total, LCU	SCENARIO	18,447.50	19,369.90	20,338.40	21,355.30	22,423.10
Scenario (baseline=100)	SCENARIO	98.1	97.6	97.3	97	96.9
GDP, real, LCU	BASELINE	40,609.10	42,412.40	43,835.90	45,306.40	46,601.70
GDP, real, growth rate	BASELINE		4.4%	3.4%	3.4%	2.9%
GDP, real, LCU	SCENARIO	40,263.40	41,710.80	43,137.20	44,721.70	45,997.80
GDP, real, growth rate	SCENARIO		3.6%	3.4%	3.7%	2.9%
Scenario (baseline=100)	SCENARIO	99.1	98.3	98.4	98.7	98.7
Consumption, private, real, LCU	BASELINE	13,212.90	13,649.00	14,031.10	14,452.10	14,871.20
Consumption, private, real, LCU	SCENARIO	13,158.30	13,514.70	13,837.30	14,240.50	14,649.30
Scenario (baseline=100)	SCENARIO	99.6	99	98.6	98.5	98.5
Employment, total	BASELINE	2,118.80	2,152.80	2,186.70	2,219.90	2,253.00
Employment, total	SCENARIO	2,106.20	2,126.10	2,158.00	2,193.50	2,225.40
Scenario (baseline=100)	SCENARIO	99.4	98.8	98.7	98.8	98.8

		2018	2019	2020	2021	2022
Consumer price index	BASELINE	113.6	116.4	120.2	123.9	127.6
Consumer price index	SCENARIO	113.4	115.2	117.1	118.6	120.8
Scenario (baseline=100)	SCENARIO	99.8	99	97.3	95.7	94.7
Government balance, share of GDP	BASELINE	3	9.2	8	6.1	5.2
Government balance, share of GDP	SCENARIO	-4.2	-11.2	-18.2	-7.6	-7.8
Scenario (pp diff)	SCENARIO	-7.2	-20.5	-26.2	-13.8	-12.9
Current account of balance of payments in LCU, share of GDP	BASELINE	13.2	16	11.9	8.7	7.7
Current account of balance of payments in LCU, share of GDP	SCENARIO	6.9	-1.2	-8.5	-0.6	-1.1
Scenario (pp diff)	SCENARIO	-6.3	-17.2	-20.4	-9.3	-8.7

Scenario 2: Model courtesy of Oxford Economics. Baseline is Oxford Economics baseline scenario.

SCENARIO 2

Our forecast vs. Oxford Economics Baseline Scenario

		2018	2019	2020	2021	2022
World oil price, Brent crude spot,$pb	BASELINE	77.7	82	75.8	73.2	75.3
World oil price, Brent crude spot,$pb	SCENARIO	65	49.5	40.7	52.5	55
Scenario (baseline=100)	SCENARIO	83.7	60.4	53.7	71.7	73.1
Government revenue, oil	BASELINE	17,803.50	21,195.60	21,201.70	21,039.00	21,254.30
Government revenue, oil	SCENARIO	14,915.30	12,896.20	11,489.10	15,220.90	15,637.70
Scenario (baseline=100)	SCENARIO	83.8	60.8	54.2	72.3	73.6
Government revenue, non-oil	BASELINE	2,297.40	3,135.20	3,600.60	4,049.30	4,586.30
Government revenue, non-oil	SCENARIO	2,246.20	2,931.00	3,273.10	3,724.20	4,191.90
Scenario (baseline=100)	SCENARIO	97.8	93.5	90.9	92	91.4
Government revenue, total, LCU	BASELINE	20,100.90	24,330.80	24,802.40	25,088.30	25,840.60
Government revenue, total, LCU	SCENARIO	17,161.40	15,827.10	14,762.20	18,945.10	19,829.60
Scenario (baseline=100)	SCENARIO	85.4	65	59.5	75.5	76.7
Government expenditure, total, LCU	BASELINE	18,796.60	19,848.00	20,912.80	22,024.00	23,137.30
Government expenditure, total, LCU	SCENARIO	18,787.80	19,839.90	20,911.30	22,019.60	23,142.60
Scenario (baseline=100)	SCENARIO	100	100	100	100	100
		2018	**2019**	**2020**	**2021**	**2022**
GDP, real, LCU	BASELINE	40,609.10	42,412.40	43,835.90	45,306.40	46,601.70
GDP, real, growth rate	BASELINE		4.4%	3.4%	3.4%	2.9%
GDP, real, LCU	SCENARIO	40,107.90	40,773.30	41,674.00	43,848.40	45,436.10
GDP, real, growth rate	SCENARIO		1.7%	2.2%	5.2%	3.6%
Scenario (baseline=100)	SCENARIO	98.8	96.1	95.1	96.8	97.5
Consumption, private, real, LCU	BASELINE	13,212.90	13,649.00	14,031.10	14,452.10	14,871.20
Consumption, private, real, LCU	SCENARIO	13,168.90	13,438.90	13,587.30	13,982.00	14,461.20
Scenario (baseline=100)	SCENARIO	99.7	98.5	96.8	96.7	97.2
Employment, total	BASELINE	2,118.80	2,152.80	2,186.70	2,219.90	2,253.00
Employment, total	SCENARIO	2,100.50	2,091.30	2,101.30	2,153.10	2,194.30
Scenario (baseline=100)	SCENARIO	99.1	97.1	96.1	97	97.4
		2018	**2019**	**2020**	**2021**	**2022**
Consumer price index	BASELINE	113.6	116.4	120.2	123.9	127.6
Consumer price index	SCENARIO	113.6	115.2	117.1	118.6	120.8
Scenario (baseline=100)	SCENARIO	99.8	99	97.3	95.7	94.7
Government balance, share of GDP	BASELINE	3	9.2	8	6.1	5.2
Government balance, share of GDP	SCENARIO	-4.2	-11.2	-18.2	-7.6	-7.8
Scenario (pp diff)	SCENARIO	-7.2	-20.5	-26.2	-13.8	-12.9
Current account of balance of payments in LCU, share of GDP	BASELINE	13.2	16	11.9	8.7	7.7
Current account of balance of payments in LCU, share of GDP	SCENARIO	6.9	-1.2	-8.5	-0.6	-1.1
Scenario (pp diff)	SCENARIO	-6.3	-17.2	-20.4	-9.3	-8.7

Scenario 2: Model courtesy of Oxford Economics. Baseline is Oxford Economics baseline scenario.

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