Kuwait's budget deficit widened in FY19/20 on lower oil prices

> Issa Hijazeen
Senior Economist
+965 2259 5359
IssaHijazeen@nbk.com

> Daniel Kaye
Head of Research
+965 2259 3136
Danielkaye@nbk.com

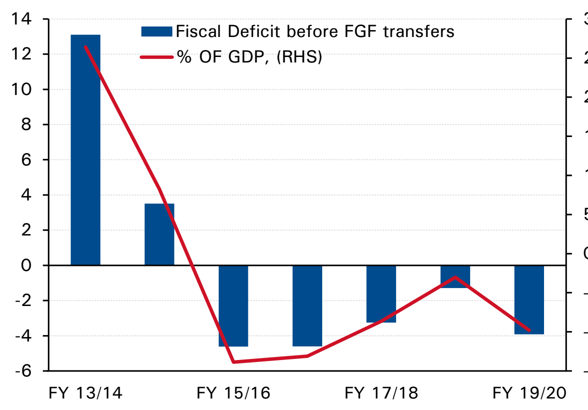
Highlights

- **The fiscal deficit in FY19/20 stood at KD 3.9 billion or 9.8% of GDP due to lower oil prices, and could more than double in the current fiscal year.**
- **GRF resources used to finance the deficits are being depleted, underscoring the necessity of passing the debt law to deal with the short-term needs of combatting the Covid-19 pandemic and supporting the economy.**
- **At the same time, there is a need for a medium-term comprehensive reform plan aimed at addressing fiscal sustainability and enhancing the role of the private sector in economic activity.**

Kuwait's fiscal position remained under pressure during FY19/20 due to low oil prices, leading to a continued draw down from the government's financial reserves. The deficit increased to KD 3.9 billion before the transfer of 10% of revenues to the Future Generation Fund (FGF), or 9.8% of 2019 GDP. This compares with a deficit of KD 1.3 billion, or 3.1% of GDP in the previous fiscal year. After the usual FGF transfers, the deficit would be KD 5.6 billion (14.1% of GDP), compared to KD 3.4 billion (7.9% of GDP) a year earlier. (Chart 1.) However parliament have recently approved the suspension of these transfers for last year and any future deficit years. The widening deficit was driven by lower oil prices, the fall in which accelerated sharply in March due to the global spread of the Covid-19 pandemic.

Chart 1: Fiscal balance

(KD billion)

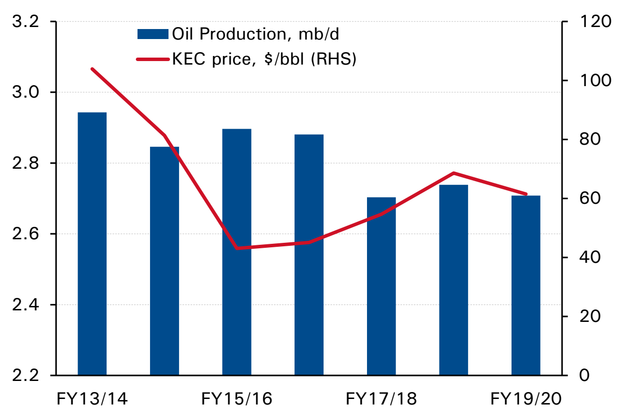


Source: Ministry of finance, CSB

Oil revenues drop on lower prices and production

Oil revenues, which constituted 89% of total revenues, declined in FY19/20 on the back of a 10.3% fall in the price of Kuwait Export Crude (KEC). (Chart 2.) In addition, oil production fell by 1.1% as per the OPEC+ agreement to cut oil production. As a result, hydrocarbon revenues declined 16.6%, despite some support from rising gas receipts. Still, oil revenues came in at 111% above budget largely due to higher-than-expected oil prices of $61.5/bbl versus $55/bbl projected in the budget.

Chart 2: Kuwait's oil production* and oil prices



Source: OPEC, * OPEC direct communication oil production data

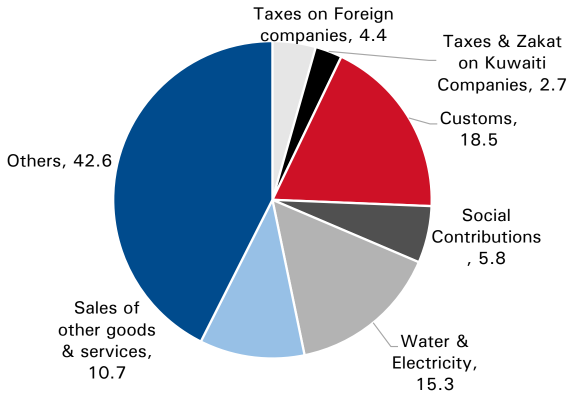
On the other hand, non-oil revenues fell by 13.1% following an increase of 24% in the previous year, due to a 7.7% decline in taxes and fees. Taxes on foreign corporations decreased 26.1% due to weak economic activity, which was also reflected in lower imports and customs proceeds (-3.6%) compared to FY18/19.

In addition, the proceeds of electricity and water (worth around 15% of total non-oil revenues) plummeted 15.5% and 36.3%, respectively, while earnings from other goods & services fell by 41% to KD 69 million. In contrast, the United Nations Compensation Commission data showed a notable increase in Iraqi compensation transfers to KD 0.3 billion in FY19/20 from KD 0.1 billion in the previous fiscal year.

Meanwhile, the data also reveals that accrued debt due to the government, which includes unpaid utility bills, remains relatively high at 4.1% of GDP. Recouping these amounts would require stricter enforcement and an enhanced level of efficiency in the government collection system.

Chart 3: Non-oil revenues main components

(% of total non-oil revenues)



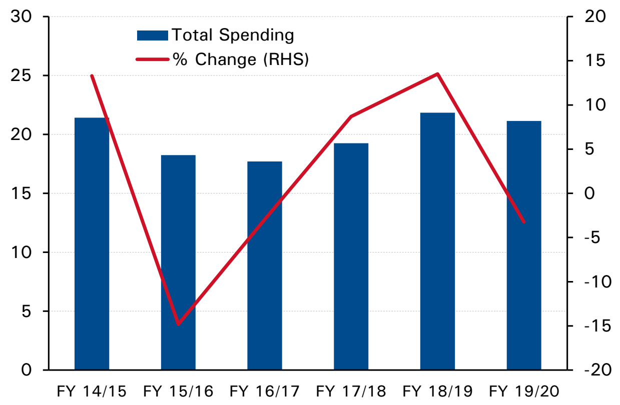
Source: Ministry of Finance

Lower subsidies drove the reduction in current spending

In the context of a persistent budget deficit and calls to reduce wasteful public spending, the government trimmed its outlays by 3.2% to KD 21.1 billion last year. (Chart 4.) This represented 94% of the originally budgeted total. Current spending fell by 2.1% to KD 18.8 billion, mainly driven by a sharp 57% fall in (mostly) oil sector subsidies to KD 0.6 billion. Although the precise cause of this fall is not clear, we think it may be mostly due to a decline in arrears payments made to Kuwait Petroleum Corporation, which were exceptionally large in FY18/19. Excluding this subsidy category, current spending would have risen 2% last year, still pointing to a degree of spending restraint.

Chart 4: Total government spending

(% change)



Source: Ministry of Finance

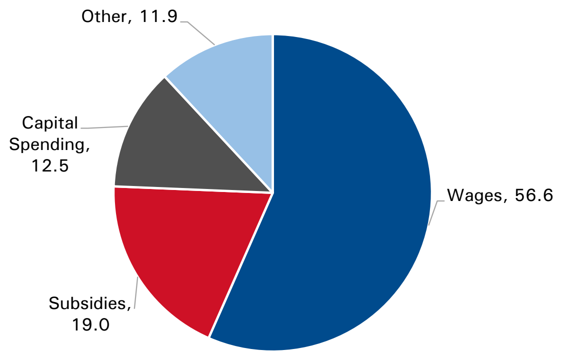
Upward pressure on spending came from compensation of employees (around 40% of current spending), which increased by 5.6%, following an increase of 6.5% rise in FY18/19. In addition, purchases of goods & services increased by 6.4% on the back of an 11.0% increase in the purchases of fuel for electricity generation and water distillation plants to reach KD 1.5 billion, despite lower fuel prices. Finally, grants – mainly transfers to bodies as Kuwait University, the Public Authority of Manpower, and the Kuwait Authority for Partnership Projects – remained relatively stable at KD 5.3 billion.

Meanwhile, capital spending fell by KD 0.3 billion or 12% to KD 2.3 billion. This represented 70% of its budget allocations, which is the lowest ratio in six years and compares to 80% a year earlier. The decline in capital spending was consistent with weak project activity of recent years, due to prolonged bid negotiations and various technical difficulties. In addition, tight spending constraints aimed at curbing a growing deficit may have been a further contributing factor.

The government also presents spending data in an alternative way, which streamlines some of the above classifications. For example, some payments on wages fall outside of the compensation category mentioned above. Overall, the wage bill amounted to KD12 billion or 57% of all spending and total subsidies (some of which are also classified outside the official 'subsidies' categories) a further 19%, adding up to around to 76% of total spending. The broad classification of the spending categories is shown in chart 5 below.

Chart 5: Total spending main components

(% of total spending)



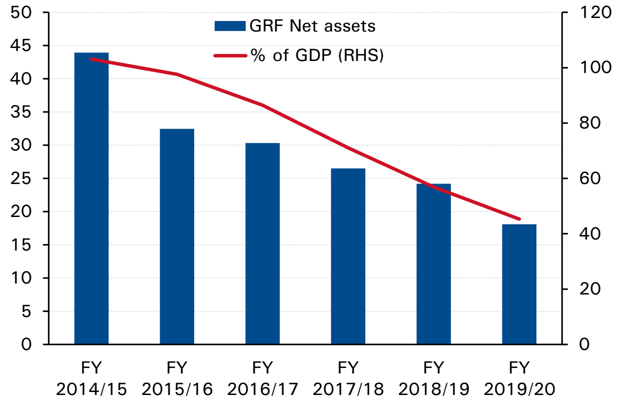
Source: Ministry of Finance

Persistent deficits pressure available reserves

Overall, the size of the deficit came in very close to our expectations and was the government's sixth consecutive post-transfers annual deficit following the drop in oil prices seen in 2014. While the government retains huge financial resources of more than $500 billion in its main sovereign wealth funds, the persistent deficits of recent years have drained those available in the General Reserve Fund (GRF) used mainly for budget financing. This has become even more pressing since the expiration of the debt law in 2017, which left GRF reserves as the sole means of financing. According to the State Audit Bureau, the GRF had net assets of KD22.9 billion remaining in June 2019. Based upon reasonable assumptions, this may have declined to around KD18 billion at the end of FY19/20 (Chart 6.). The remaining liquid assets are likely to have been considerably lower.

Chart 6: GRF net assets*

(KD billion, end year)



Source: Audit Bureau, CSB
* NBK estimate for FY19/20

The collapse of oil prices in 2020 will pressure the GRF

The dwindling of GRF resources have continued in the first few months of this fiscal year, given the weakness of oil prices (which averaged just $30/bbl in the first four months) and pressures on spending linked to the Covid-19 pandemic. For FY20/21 as a whole, the deficit could reach more than KD 10 billion, or 32% of GDP based upon an average KEC oil price of just below $40/bbl and a cut in spending of 5% to KD20 billion. This would deplete the majority of the remaining funds in the GRF. Indeed these pressures are already evident with the news that the government swapped KD2.1 billion in GRF assets for more liquid FGF assets recently to keep financing its operations.

The government has proposed a range of potential measures aimed at trimming the deficit going forward. These include implementing both an excise duty and VAT (KD 0.8 billion), a 5% profit tax (KD 0.5 billion), a rise in utility fees (KD0.5 billion) and an increase in charges for other government services. The total impact of these measures are estimated at KD 5.0 billion. However, most of these reforms require parliamentary approval and are unlikely to be implemented soon. We would therefore expect a mild impact on the current fiscal year. In the near term, efforts to address the budget deficit are likely to focus more on cuts in non-essential spending as well as freeing up financing options such as the recent GRF/FGF asset swap and the now-approved suspension of the 10% transfers to the FGF when the budget is in deficit.

However, the need for deep and wide-ranging fiscal reforms is becoming more and more urgent. The recent S&P downgrade to Kuwait's sovereign credit rating outlook to negative from stable is a warning sign reflecting the depletion of GRF resources and the absence of both a new debt law as well as reforms comparable to those seen in most other Gulf countries. Reforms should target rationalizing spending, promoting public private partnerships to reduce the cost of government projects, and mobilizing more non-oil revenues. Of course, for now, priority should be given to containing and eradicating the Covid-19 pandemic, which makes the passing of the debt law absolutely essential.

Kuwait could benefit from its good rating and low interest rate environment to borrow at competitive rates. But this does not mean that it will be "good debt" unless it is used for productive purposes (efficient physical and human capital investment) based on a clear and comprehensive medium-term reform plan. Such a plan should focus on addressing macroeconomic imbalances, chief among them is fiscal sustainability, and implementing structural reforms aimed at enhancing the role of the private sector in economic activity and creating jobs for the large number of nationals expected to enter the labor force.

Table 1: Public finances, KD billion unless otherwise stated

	FY			% y/y		% of GDP	
	FY17/18	FY18/19	FY19/20	FY18/19	FY19/20	FY18/19	FY19/20
Revenues	16.0	20.6	17.2	28.5	-16.2	48.4	43.1
Non-oil	1.7	2.1	1.9	24.0	-13.1	5.0	4.6
Oil	14.3	18.4	15.4	29.0	-16.6	43.4	38.4
Total Expenditures	19.3	21.9	21.1	13.6	-3.3	51.4	52.9
Current Expenditures	16.7	19.2	18.8	14.9	-2.1	45.2	47.1
Compensation of Employees	6.7	7.2	7.6	6.5	5.6	16.9	19.0
Goods & Services	2.8	3.0	3.2	6.7	6.4	7.1	8.0
Subsidies	0.3	1.4	0.6	...	-56.6	3.4	1.5
Grants	4.7	5.2	5.3	12.0	0.2	12.3	13.1
Social Subsidies	1.1	1.0	1.0	-7.9	-2.2	2.3	2.4
Miscellaneous & Transfers	1.1	1.4	1.2	26.0	-12.0	3.3	3.1
Capital Expenditures	2.5	2.6	2.3	5.0	-12.6	6.2	5.8
Budget Balance	-3.3	-1.3	-3.9	...	...	-3.1	-9.8
RFFG transfers*	1.6	2.1	1.7	28.5	-16.2	4.8	4.3
Budget Bal. after RFFG transfers*	-4.9	-3.4	-5.6	...	...	-7.9	-14.1

Source: Ministry of Finance
* Transfers to the FGF were suspended for FY19/20; shown here for illustrative purposes.

Head Office

Kuwait
National Bank of Kuwait SAKP
Abdullah Al-Ahmed Street
P.O. Box 95, Safat 13001
Kuwait City, Kuwait
Tel: +965 2242 2011
Fax: +965 2259 5804
Telex: 22043-22451 NATBANK
www.nbk.com

International Network

Bahrain
National Bank of Kuwait SAKP
Zain Branch
Zain Tower, Building 401, Road 2806
Seef Area 428, P. O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

National Bank of Kuwait SAKP
Bahrain Head Office
GB Corp Tower
Block 346, Road 4626
Building 1411
P.O. Box 5290, Manama
Kingdom of Bahrain
Tel: +973 17 155 555
Fax: +973 17 104 860

United Arab Emirates
National Bank of Kuwait SAKP
Dubai Branch
Latifa Tower, Sheikh Zayed Road
Next to Crown Plaza
P.O.Box 9293, Dubai, U.A.E
Tel: +971 4 3161600
Fax: +971 4 3888588

National Bank of Kuwait SAKP
Abu Dhabi Branch
Sheikh Rashed Bin Saeed
Al Maktoom, (Old Airport Road)
P.O.Box 113567,Abu Dhabi, U.A.E
Tel: +971 2 4199 555
Fax: +971 2 2222 477

Saudi Arabia
National Bank of Kuwait SAKP
Jeddah Branch
Al Khalidiah District,
Al Mukmal Tower, Jeddah
P.O Box: 15385 Jeddah 21444
Kingdom of Saudi Arabia
Tel: +966 2 603 6300
Fax: +966 2 603 6318

Jordan
National Bank of Kuwait SAKP
Amman Branch
Shareef Abdul Hamid Sharaf St
P.O. Box 941297, Shmeisani,
Amman 11194, Jordan
Tel: +962 6 580 0400
Fax: +962 6 580 0441

Lebanon
National Bank of Kuwait
(Lebanon) SAL
BAC Building, Justinien Street, Sanayeh
P.O. Box 11-5727, Riad El-Solh
Beirut 1107 2200, Lebanon
Tel: +961 1 759700
Fax: +961 1 747866

Iraq
Credit Bank of Iraq
Street 9, Building 187
Sadoon Street, District 102
P.O. Box 3420, Baghdad, Iraq
Tel: +964 1 7182198/7191944
+964 1 7188406/7171673
Fax: +964 1 7170156

Egypt
National Bank of Kuwait - Egypt
Plot 155, City Center, First Sector
5th Settlement, New Cairo
Egypt
Tel: +20 2 26149300
Fax: +20 2 26133978

United States of America
National Bank of Kuwait SAKP
New York Branch
299 Park Avenue
New York, NY 10171
USA
Tel: +1 212 303 9800
Fax: +1 212 319 8269

United Kingdom
National Bank of Kuwait
(International) Plc
Head Office
13 George Street
London W1U 3QJ
UK
Tel: +44 20 7224 2277
Fax: +44 20 7224 2101

National Bank of Kuwait
(International) Plc
Portman Square Branch
7 Portman Square
London W1H 6NA, UK
Tel: +44 20 7224 2277
Fax: +44 20 7486 3877

France
National Bank of Kuwait France SA
90 Avenue des Champs-Elysees
75008 Paris
France
Tel: +33 1 5659 8600
Fax: +33 1 5659 8623

Singapore
National Bank of Kuwait SAKP
Singapore Branch
9 Raffles Place # 44-01
Republic Plaza
Singapore 048619
Tel: +65 6222 5348
Fax: +65 6224 5438

China
National Bank of Kuwait SAKP
Shanghai Office
Suite 1003, 10th Floor, Azia Center
1233 Lujiazui Ring Road
Shanghai 200120, China
Tel: +86 21 6888 1092
Fax: +86 21 5047 1011

NBK Capital

Kuwait
NBK Capital
38th Floor, Arraya II Building, Block 6
Shuhada'a street, Sharq
PO Box 4950, Safat, 13050
Kuwait
Tel: +965 2224 6900
Fax: +965 2224 6904 / 5

United Arab Emirates
NBK Capital Limited - UAE
Precinct Building 3, Office 404
Dubai International Financial Center
Sheikh Zayed Road
P.O. Box 506506, Dubai
UAE
Tel: +971 4 365 2800
Fax: +971 4 365 2805

Associates

Turkey
Turkish Bank
Valikonagl CAD. 7
Nisantasi, P.O. Box. 34371
Istanbul, Turkey
Tel: +90 212 373 6373
Fax: +90 212 225 0353