Economic Update

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Kuwait outlook

الوطني NBK

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

Non-oil growth seen steady this year, as higher oil prices boost fiscal position

Highlights

- **GDP growth is set to rebound to 2.5% this year with oil production rising due to the shift in OPEC policy.**
- **Non-oil growth is seen broadly steady at 3.5%, but reforms are needed to boost longer-term growth potential.**
- **The pipeline of scheduled project awards is decent and last year's recovery in consumer spending remains intact.**
- **Inflation is forecast at just 1.0% in 2018 on soft food and housing figures.**
- **The fiscal deficit is set to fall to 5% of GDP in FY2018/19 despite a planned increase in spending.**
- **Credit growth has been subdued on weak corporate demand and the central bank kept lending rates on hold in June.**
- **Stock market reforms have resulted in international recognition, and could trigger capital inflows later this year.**

The economy remains on an improving trend, with activity gradually expanding following the slowdown triggered by the drop in oil prices in 2014. The rise in oil prices has narrowed the fiscal deficit despite a large spending increase factored into the budget for this year, and points to a slower drawdown of the government's General Reserve fund. Total financial reserves are estimated at nearly five times' GDP – still a major cushion. The growth outlook, however, is being held back in the short term by delays in project execution and in passing the budget (approved in June). For the longer term, economic diversification and a faster pace of reform in line with some neighboring Gulf countries should improve the outlook.

GDP growth to rebound this year

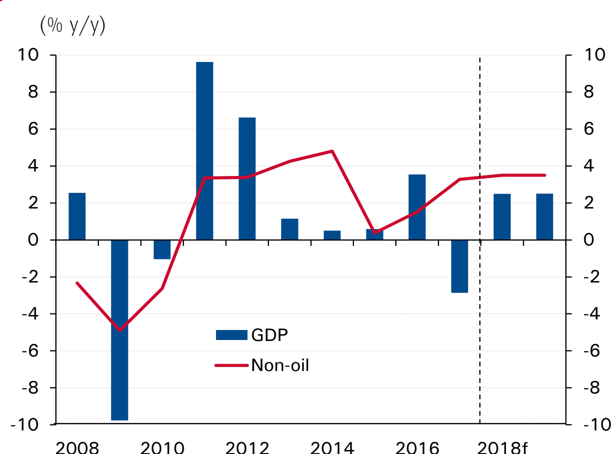
After falling 2.9% in 2017, GDP is set to rebound 2.5% this year helped in particular by higher oil output. (Chart 1.) Oil GDP fell 8.0% in 2017 as Kuwait cut its crude oil production to 2.7 million b/d in adherence with OPEC-led production goals. Output was stable in the first few months of 2018, but following OPEC's recent decision to increase output (albeit with country shares ambiguous), we forecast it to rise to 2.8 million b/d in 2H18. Oil GDP therefore rises 1.5% overall this year, and a similar amount in 2019. Work is underway to lift production capacity (excluding the neutral zone) to 3.65 million b/d from 3.15 now, which would in principle provide scope to boost output by nearly one-third in future years from current levels.

Table 1: Key economic indicators

		2016	2017f	2018f	2019f
Nominal GDP	USD bn	111	120	133	134
Real GDP	% y/y	3.5	-2.9	2.5	2.5
- Oil	% y/y	2.8	-8.0	1.5	1.5
- Non-oil	% y/y	1.5	3.3	3.5	3.5
Inflation	% y/y	3.5	1.5	1.0	2.5
Budget balance*	% of GDP	-13.8	-6.0	-5.0	-3.0

Source: Official sources, NBK estimates * Before RFFG transfers

Chart 1: Real GDP



Source: Thomson Reuters Datastream / NBK

Non-oil growth improved to 3.3% in 2017 from 1.5% in 2016 and is forecast at 3.5% this year – a solid performance by regional standards – with risks slightly to the downside. The recovery in consumer spending since 2016 has remained in place, helped by reasonable employment growth, low inflation, the fading impact of earlier subsidy cuts and the boost to

confidence from higher oil prices. Growth will also receive help from fiscal policy, which is set to return to expansion mode in FY2018/19 for the first time in four years and capital spending remains a priority (although the boost may come late in the year). This should help offset the impact of rising interest rates, which we expect to be reasonably modest.

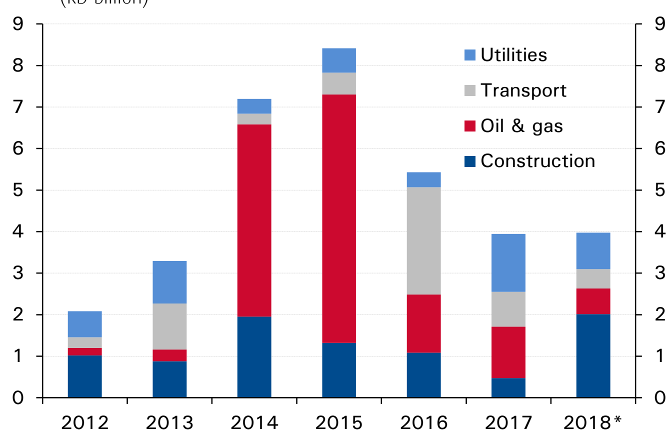
Although demand-side conditions look reasonable in the near term, structural measures are needed to boost the economy's longer-term growth potential. This includes the labor market, where the government continues to absorb the bulk of new Kuwaiti entrants to the labor force, as well as measures to improve the business environment, where Kuwait needs to make concerted efforts to catch up at least with reforms in Gulf neighbors. The government has faced substantial opposition to reforms in parliament, resulting recently in the watering down of cuts in fuel subsidies, the postponement of VAT until at least 2021 and now a delay in passage of the debt law. While rising oil prices bolster the fiscal position and support the credit rating, the concern is that they could slow the reform effort further and delay the process of economic diversification.

Project awards steady in 2018 amid optimism on PPPs

Project activity has played an important role in supporting non-oil growth in recent years, and despite continued delays, the pipeline of awards remains decent. Around KD 4 billion in awards are scheduled for this year, similar to 2017 and boosted by a record year for construction. (Chart 2.) This is lower than in 2014 and 2015, which were lifted by large awards in the oil sector. This should underpin growth over the next few years.

Chart 2: Planned and awarded projects

(KD billion)



Source: MEED Projects * Planned or already awarded

Implementation of the government's five-year development plan (FY2015/16-2019/20) remains a key policy goal – part of the broader aim to turn Kuwait into a regional trade and financial hub by 2035. The infrastructure sector received a boost from the approval of two major PPP projects confirmed in May, as well as the issue of a new PPP guidebook. These developments could help revitalize sentiment in a sector previously bogged down with delays and cancellations.

Improved confidence helps consumer spending

The consumer sector has also supported the growth climate, having recovered from its marked slowdown of 2016 affected by falling confidence and subsidy cuts. Consumer confidence in the first five months of the year stabilized at well above year-ago levels while card spending and withdrawals rose 8% y/y in 1Q18, faster than the 7% average of 2017. Our own NBK consumer spending index remained strong into 2Q18, while household lending is still solid.

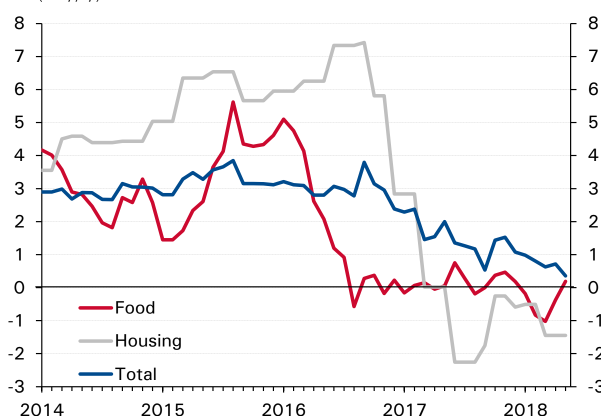
We expect consumer spending to remain supportive of growth through 2018, against a backdrop of higher oil prices, low inflation (see below), rising government spending and steady employment growth for Kuwaiti nationals. The decision to postpone the implementation of VAT until at least 2021 will also defer the hit, albeit small, to consumer incomes previously expected for next year. The main risks relate to higher interest rates – though the central bank held off on raising lending rates in June – and pressure on expat numbers as the government advances its Kuwaitization policy.

Inflation to remain very low on falling housing costs

Inflation is forecast to average a 15-year low of just 1.0% this year from 1.5% in 2017. This is slightly lower than we had previously expected, thanks to softer than expected recent outturns. Inflation stood at just 0.4% y/y in May and averaged 0.7% in 2018 year-to-date. (Chart 3.) Headline inflation has been kept low by two main factors: soft food price inflation thanks to international food prices, and continued falls in housing costs. Our measure of 'core' inflation, which excludes these components, stood at a slightly firmer 1.7% y/y in May.

Chart 3: CPI inflation

(% y/y)



Source: Thomson Reuters Datastream

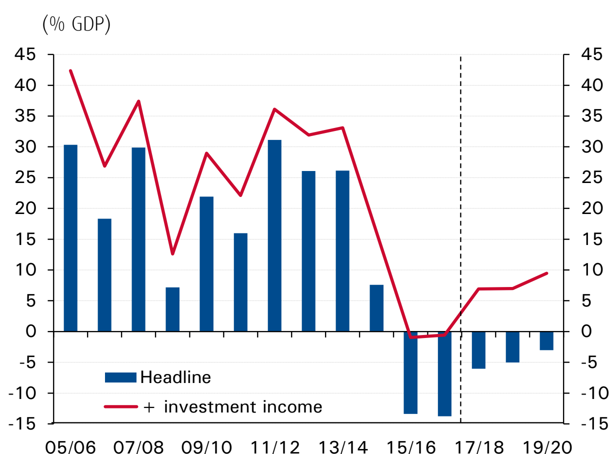
Although downward pressures from the housing and food components should ease going forward, inflationary pressures are otherwise expected to stay subdued. The US dollar, and as a result the Kuwait dinar, has strengthened slightly this year recovering some of last year's declines, and this should help reduce import cost. Core inflation should also be kept low by base effects following sizeable increases mid-last year, moderate economic growth, and – amid an improved fiscal position – the absence of planned subsidy cuts that pushed inflation higher in 2016 and 2017. Meanwhile, the delay in the implementation of VAT will no longer lift prices in 2019. Inflation next year is forecast at 2.5%.

Fiscal deficit to narrow sharply despite spending hike

Although the fiscal balance is forecast to remain in deficit over the medium term, a combination of higher oil prices and spending restraint have improved the position substantially. The deficit is estimated to have narrowed sharply to 6% of GDP in FY2017/18 from nearly 14% of GDP a year earlier. (Chart 4.) Oil revenues – worth 90% of the total – rose 24% y/y thanks to a similar-size rise in the price of Kuwait Export Crude to $54/bbl on average. Meanwhile, spending is estimated to have risen just 3% after a cumulative cut of 17% during the previous two years.

Chart 4: Fiscal balance*

(% GDP)



Source: Ministry of Finance / NBK * Before transfers to RFFG

Spending under the government's draft budget for FY2018/19 was originally capped at KD20 billion, but revised up to KD21.5 billion albeit including some one-off items and higher transfer payments due to rising oil prices. The budget law was finally passed in late-June and points to a hefty 10% increase in spending this year and should provide a sizeable boost to demand in the economy. However the deficit is still forecast to narrow slightly to 5% of GDP on rising oil prices and production. Some of the one-off spending items will drop out the following year, allowing the deficit to narrow a touch further despite our forecast of slightly lower oil prices.

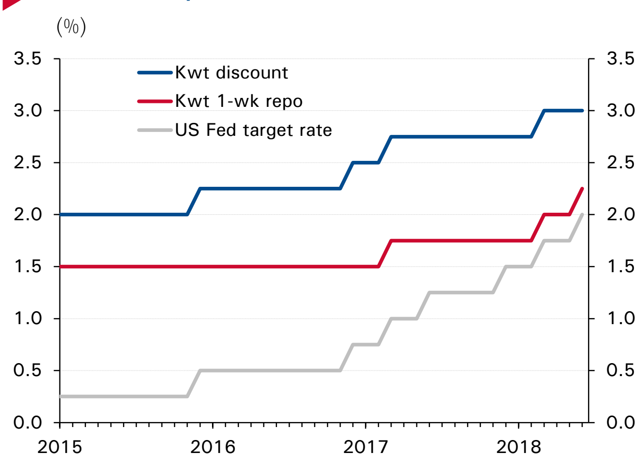
Despite the persistent deficits, the country's financial position remains extremely strong with accumulated savings from earlier surpluses leaving sovereign wealth fund assets estimated at $550-600 billion, or up to five times' GDP and underpinning the very strong AA credit rating. Annual returns on these assets – not included in the headline fiscal accounts – are estimated at 12-13% of GDP. Since April 2016, the government has met around half of its funding needs through debt issuance, including an inaugural $8 billion sovereign bond in March 2017. Overall government debt levels remain low at around 19% of GDP in March 2018, with the government still waiting for parliament's approval of the draft debt law that would push the borrowing limit to KD 25 billion from KD 10 billion under the previous law.

CBK lending rate left on hold in June; credit growth soft

Monetary policy remains geared towards maintaining the dinar's peg to a basket of currencies dominated by the US dollar. The central bank left its lending rate on hold at 3.0% in June following the 25bps hike by the US Federal Reserve, having raised its key rates in March following the Fed's previous move. (Chart 5.) The exchange rate system provides Kuwait with greater policy flexibility than other GCC countries that operate direct pegs to the dollar. By keeping its policy rate on hold in June, the central bank is looking to support economic growth while using other monetary policy instruments to ensure the stability of the dinar. The CBK implied that banks can raise their deposit rates without changing lending rates, which are benchmarked to the discount rate. Subsequently, it raised its repo rates by 25 basis points and banks followed and raised their deposit rates by the same amount.

Chart 5: Policy interest rates

(%)



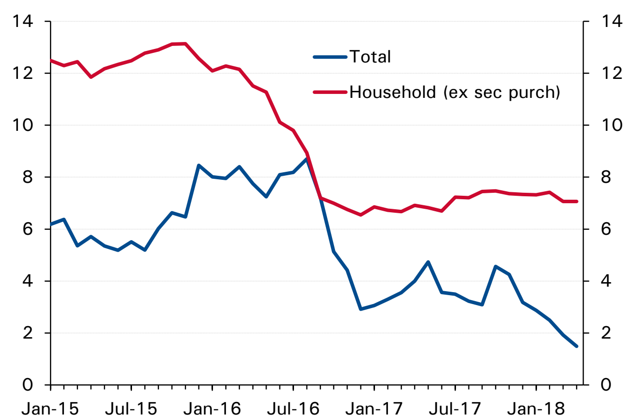
Source: Thomson Reuters Datastream / CBK

Credit growth has decelerated and reached a six-year low of 1.5% y/y in April, mostly reflecting weakness in business lending though affected by some exceptional one-off corporate repayments in 2017. (Chart 6.) Lending to households

(normally for home purchases) has been more solid at 7-8% y/y (excluding securities lending) for most of the past year. Although likely to remain moderate overall, credit growth should be boosted later in 2018 by the expansionary budget for FY18/19, recent project awards translating into loan demand including in the important oil sector, and the base effect from last year's repayments.

Chart 6: Bank credit

(% y/y)



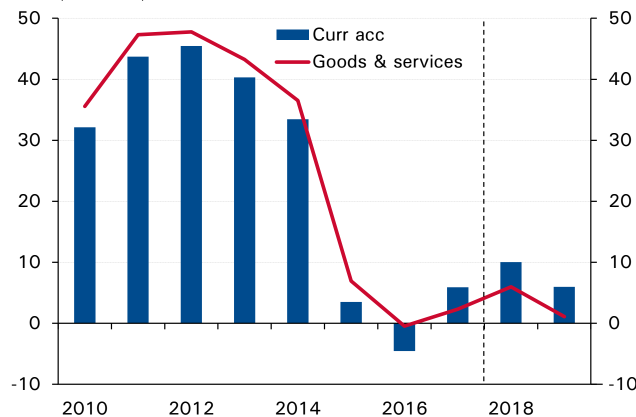
Source: Thomson Reuters Datastream / NBK

External position improving on higher oil prices

Low oil prices saw Kuwait record its first current account deficit in modern history in 2016, but the external position recovered last year, recording a surplus of 5.9% of GDP. (Chart 7.) The improvement was due to a 19% rise in oil exports driven by higher oil prices; oil receipts account for around 90% of all merchandise exports. Goods imports rose a decent 10% y/y, boosted by stronger domestic demand and imports of capital goods. A rise in the surplus to 10% of GDP is forecast for this year – modest by historic standards – as oil exports are lifted by another rise in oil prices, while import growth remains solid.

Chart 7: Current account balance

(% of GDP)

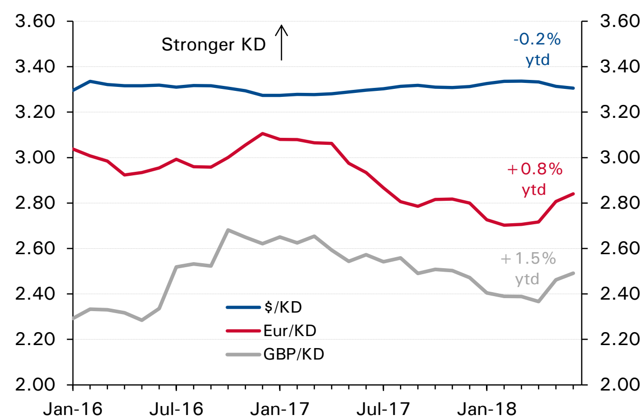


Source: Thomson Reuters Datastream / NBK

The dinar retreated in 2017 due to the slide in the US dollar, which fell 8% on a trade-weighted basis including 10% versus the euro on improving growth outside the US and the unwinding of previous dollar strength. So far in 2018, the dinar has climbed slightly against other currencies and held broadly steady against the dollar, which has been boosted by buoyant US growth and expectations of higher interest rates. (Chart 8.)

Chart 8: Kuwaiti dinar versus other currencies

(FC per dinar)



Source: Thomson Reuters Datastream

Stock market receives upgrade, but activity is thin

The stock market received a boost with news in June that global index provider MSCI will consider upgrading Kuwait to Emerging Market status in June 2019, with competitor provider FTSE Russell already committed to doing so in two phases in September and December this year. If it materializes, the MSCI upgrade could lead to even larger inflows than the $0.8 billion expected from the FTSE upgrade. The announcements follow a period of reform in the stock market with a view to improving the market's attractiveness, especially to foreign investors and ahead of a planned IPO. The latest of these occurred in April 2018, which saw listed firms allocated to one of three new market segments depending upon factors including size, liquidity and governance, as well as the introduction of new market indices.

Despite the reforms and higher oil prices, the Kuwaiti market has been flat for most of this year, underperforming the regional average, but has picked up following index reclassification dynamic. Daily trading values have averaged around KD 11 million so far in 2018, very low compared to earlier years. One factor may be modest rates of non-oil economic growth, but investors may also be more taken with developments in larger, nearby overseas markets such as Saudi Arabia and the UAE, where the economic reform climate is more compelling. However, some pick up in volumes and performance has been seen recently, with daily trade volumes averaging KD 21 million in the two weeks that followed the

MSCI announcement and as the inclusion into FTSE gets closer. Momentum is expected to persist with further inflows from the FTSE upgrade and the pending listing of crane and heavy equipment operator IHC possible catalysts.

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
(International) Plc
Paris Branch
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

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